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The Canadian Mortgage Market

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Preface

Two years ago I was approached by the Office of Economic Policy of the Ontario Department of Treasury, Economics and Intergovernmental Affairs to do a study of the mortage market for the Joint Committee on Economic Policy. The objective of the study was to describe and analyze the market for residential mortgages emphasizing the market participants, the decision rules they employed and the major issues confronting the market. When preliminary findings were presented to the Joint Committee, it was decided that the study should be published in book form. The result was this publication.

Funding for this study was provided by the Joint Committee on Economic Policy and the Associates' Plan for Excellence of the School of Business Administration at the University of Western Ontario. I would like to express sincere appreciation to both of these sources since without their support this work would clearly not have been possible.

An author is indebted to a large number of persons both directly and indirectly. In the course of the study many people in government and business were interviewed. Everyone contacted gave of their time generously and in a real sense this is their book. I would like to acknowledge the contributions of Aldyth Holmes, Dave Das Gupta of CMHC, Laurie Townsend of the Toronto-Dominion Bank, Ed Miller of Canada Trust and Peter Goring of Canmort Consultants, all of whom provided special assistance with the field work. David Redgrave, Brock Smith, Shirley Haggart and Joyce Pearce of the Province of Ontario provided valuable technical support. The entire manuscript was read and critiqued by two very capable and understanding persons; David Mansur, former president of CMHC and Kinross Mortgage Corporation and Reginald Ryan, president of the Mortage Insurance Company of Canada. Many hours of typing were capably provided by Norene Culp, Jean Fish and Anna Zupancic. My secretary Nina Hanck worked tirelessly and with good humour throughout the project.

James E. Hatch
London, Ontario
September, 1975

To Dolores, Karen and Michelle

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Chapter 1

Introduction

The objective of this study is to describe and analyze the characteristics of the Canadian residential mortgage market. Since the demand for residential mortgages is derived from the need for and the supply of housing, it is inevitable that there be some discussion of housing. However, this study will focus primarily upon the question of how housing is financed rather than on the broader economic and social issues.

This study was commissioned in 1973 by the Joint Committee on Economic Policy of the Province of Ontario to fill a gap in available mortgage market information.[1] The financing of housing is a controversial topic which is of concern to a broad cross section of Canadian individuals, businessmen and governments. In spite of this concern, little information is available on the functioning of the mortgage market and, in particular, on the behaviour of the various market participants. Therefore, it was decided that a book be written to describe and analyze the mortgage market, focusing on its institutions and the legislative and operational constraints they are under, as well as the kinds of decision rules they employ.

The first task was to review all existing literature and to supplement it by conducting numerous interviews with knowledgable persons in the business. The next step was to submit a draft of the book to persons in government and industry for comments on its completeness and descriptive accuracy. This was followed by further investigation and the writing of a final draft. Throughout the period of writing, the mortgage market changed in many respects with the creation of new institutions, the further development of a secondary market, and the introduction of several new government programs. These changes have been incorporated in this volume.

1. The Joint Committee on Economic Policy was established to assist in the development of future economic policy for the Province. The formal activities of the Committee terminated in August 1974. During its existence, the Committee sponsored a number of studies and reviewed position papers on matters of current economic interest. A final report was prepared entitled *Directions for Economic and Social Policy in Ontario*, Toronto: Queen's Printer, 1974. A list of other studies for the Joint Committee is included in its final report.

OTHER STUDIES OF THE MORTGAGE MARKET

On the presumption that the reader has a general interest in the mortgage market, it is useful to review some of the other publications that are available in this area.

If one were to examine the bookshelf of a mortgage lender, one would likely find *Canadian Mortgages*, a classic written by H. Woodard in 1959.[2] This book deals primarily with the administrative and legal aspects of mortgages. It is written in a style which makes reading easy and informative and although it was published some years ago, it continues to be a useful reference.

A number of studies have been sponsored by government. In 1969, a Federal Task Force on Housing and Urban Development, led by Paul Hellyer, produced a report on housing and urban development.[3] The report contains a number of observations of the mortgage market as well as recommendations for change, several of which were subsequently adopted.

At the same time the Hellyer report was released, the Bank of Canada published a staff research study which discussed the structure of RDX1, an econometric model of the Canadian economy.[4] The model, and its successor RDX2, contain equations which, among other things, are intended to reflect the functioning of the housing and mortgage markets.[5] A detailed discussion of the research underlying the housing and mortgage market equations used in RDX1 is contained in a study published by Lawrence Smith in 1970.[6] Smith, in a study undertaken for the Federal Ministy of Housing in 1971, outlined the forces operating in the Canadian housing market which encompassed aspects of the mortgage market.[7] Smith and Sparks produced a study in 1973 in which they employed an econometric model in an attempt to explain institutional mortgage lending in Canada over the period 1954 to 1968.[8]

2. H. Woodard, *Canadian Mortgages*, Toronto: Collins Publishing, 1959.

3. *Report of the Federal Task Force on Housing and Urban Development*, Ottawa: Information Canada, 1969.

4. John Helliwell, Lawrence Officer, Harold Shapiro and Ian Stewart, *The Dynamics of RDX1*, Ottawa: Bank of Canada, 1969.

5. John Helliwell, Harold Shapiro, Gordon Sparks, Ian Stewart, Frederick Gorbett and Donald R. Stephenson, *The Structure of RDX2 Parts I and II*, Ottawa: Bank of Canada, 1971.

6. Lawrence B. Smith, *Housing and Mortgage Markets in Canada*, Ottawa: Bank of Canada, 1970.

7. Lawrence B. Smith, *Housing in Canada*, Ottawa: CMHC, 1971.

8. Lawrence B. Smith and Gordon Sparks, *Institutional Mortgage Lending in Canada, 1954-1968: An Econometric Analysis*, Ottawa: Bank of Canada, 1973.

In August 1973, an Ontario Advisory Task Force on Housing Policy published a report dealing with housing in Ontario.[9] There is some mention of the mortgage market in the report but its primary thrust is a discussion of existing and proposed government programs.

Perhaps the most comprehensive book on the housing and mortgage markets was published by Lawrence Smith in 1974.[10] The book combines descriptions of the housing and mortgage markets with an econometric model of these markets. The study draws heavily on the author's previous work mentioned above.

Central Mortgage and Housing Corporation commissioned a Special Project Team on New Financing Mechanisms and Institutions in 1970. The team studied three different proposals for improving the mortgage market: the creation of a federal mortgage exchange corporation, the creation of mortgage investment companies and the feasibility of variable terms mortgages. The study was published in mid 1975, although the work was completed several years earlier.[11]

MORTGAGE LOANS

A *mortgage* is created when a sum of money is loaned by one party to another and the lender receives, as security, an interest in real property. The owner of the property is called the *mortgagor* and the lender is called the *mortgagee.* Interests in land are recorded in a government office. There are two different systems of registration in use in Canada, the *registry system* and the *land titles system.*[12]

Under the registry system, all interests in land are recorded in a registry office. When a mortgage loan is made, title to the property passes to the lender and the borrower retains an *equity of redemption* which is the right to reacquire the title upon repayment of the loan. If the loan is not repaid according to the agreement, the lender, as a result of court action, may sell the property or take possession through foreclosure. When the lender successfully forecloses, the borrower can take no further action. If, however, the lender sells the property, or has the courts sell the property, it is recognized that any residual value or equity of redemption remaining after paying the debts and the costs of sale accrues to the borrower. Since title to the property can be held by only one party, a second mortgage lender has a claim solely on the equity of redemption and not to the title of the property itself. For this reason, if the first mortgage lender successfully forecloses

9. Ontario, *Report of the Advisory Task Force on Housing Policy*, Toronto, August 1973.

10. Lawrence B. Smith, *The Postwar Canadian Housing and Mortgage Markets and the Role of Government,* Toronto: University of Toronto Press, 1974.

11. J.V. Poapst, ed., *Developing the Residential Market,* I, II, III, Ottawa: CMHC, 1975.

12. The land titles system is used in the three most westerly provinces and in parts of Manitoba and Ontario. The registry system is used in parts of Manitoba and Ontario and in the Maritimes. The Quebec system is somewhat like a land titles system. Most new subdivisions in Ontario are under the land titles system.

on a property, the second mortgage lender has only a general creditor's claim on the borrower. However, if default occurs and the property is sold, the second mortgage lender can claim the amount owing to him from any residual arising out of the settlement of the first mortgage lender's claim. If the first mortgage is in default, the second mortgage lender, in order to protect his investment, may either pay off the first mortgage lender or correct the default by making the payments in arrears.

Under the land titles system, the borrower retains legal title to the property. The first and subsequent mortgages are treated as liens that rank according to the order in which they were recorded. In the event that default occurs, and following a court order, the property is sold by the borrower or the courts. Proceeds of the sale are distributed to the lenders in accordance with the priority of their claims and the residual goes to the borrower.

MORTGAGE LOANS ON EXISTING AND NEW PROPERTIES

A loan may be obtained by pledging a property which has existed for some time. The loan is usually taken out to purchase the property but the funds may also be used for other purposes. Funds can be obtained from individuals or institutions. Although an individual can make a mortgage loan quite easily, financial institutions are subject to a number of legal and other constraints which restrict their lending. It is often the case that the first mortgage on an existing property is provided by a major financial institution such as a bank or a trust company, while the second mortgage is funded by a vendor, some other individual or a finance company. Although second mortgages will be discussed, the primary concern of this study is first mortgage loans made by financial institutions.

Lending procedures for newly constructed properties are more complex than for existing properties. Most loans on new properties are made to builders or developers who are either building several houses for speculative sale or constructing an apartment building or commercial property for rent or sale. The borrower normally requires a commitment from the lender which states that funds will be provided at some future date. The commitment may be a construction advance commitment or a takeout commitment. Under the *construction advance commitment*, the lender provides funds to the builder at various stages of construction, making the final advance upon satisfactory completion of the structure. When the property is completed and sold by the builder, the new owner, after receiving the lender's approval, assumes the mortgage. Under a *takeout commitment,* the lender provides the total mortgage loan upon satisfactory completion of the building. In utilizing this commitment method, the builder must obtain interim financing from some other source for the land, installation of services, and the construction labor and materials. Even if he has arranged for progress advances, the builder must still obtain some interim financing to cover the gap between cash outlays and mortgage loan advances. The result is that there is a substantial interim financing industry which is closely tied to the mortgage market. Although the primary concern of this paper is mortgage loans, interim financing will be examined as well.

NHA, CONVENTIONAL AND HIGH RATIO MORTGAGES

Under certain circumstances, a lending institution may make a mortgage loan to a homeowner or builder, repayment of which is insured by the Central Mortgage and Housing Corporation (CMHC), This type of mortgage loan is called a *National Housing Act (NHA) mortgage* and those lending institutions permitted to make such a loan are called *NHA approved lenders.* Any mortgage loan which is not an NHA mortgage is called a *conventional mortgage.* Most financial institutions are not permitted to make conventional mortgage loans in excess of 75 per cent of either the selling price or the appraised value of the property, whichever is less. This *loan to value ratio* may be extended if that portion of the loan over 75 percent of the property value is insured by a mortgage insurance company. These privately insured loans have come to be known as *high ratio mortgages.*

MORTGAGES LOANS AND MORTGAGE BONDS

Since they are similar, it is useful to make a distinction between a mortgage loan and a mortgage bond. A *mortgage loan* is any loan made with the pledge of property as collateral. In the case of a *mortgage bond,* a corporation pledges a real asset as security for a loan. This pledge normally takes the form of a trust deed which is recorded in a registry office along with other mortgage claims. The terms of the trust deed are administered by a trustee who is paid by the corporation but who acts on behalf of the lenders. Because the corporation needs to raise a large amount of money, it issues a number of identical bonds sufficient to make up the total amount borrowed. These bonds are then sold to various investors. Mortgage bonds are typically issued by larger corporations and individual bonds can be traded more freely than single mortgages.

MORTGAGE MARKET PARTICIPANTS

The largest single investment decision that an individual is likely to make is the purchase of a home. In 1974, the purchase of over 160,000 single family homes was financed by Canadian financial institutions. A key element in this purchase decision was the availability and cost of mortgage funds. Similarly, the decision to construct such diverse premises as apartment buildings, low rental housing, shopping centres, office buildings and industrial warehouses depends heavily on the state of the mortgage market.

As mentioned previously, funds for mortgage loans are provided by individuals and institutions. Life insurance companies, trust companies and banks carefully evaluate the investment characteristics of mortgages when allocating funds. These institutions employ a trained staff to administer the origination and servicing of mortgage loans.

A number of professionals are available to assist borrowers and lenders. Real estate agents assist house purchasers in finding mortgage funds. Mortgage brokers perform a number of functions which vary from making specific borrowers and

lenders aware of each other to providing detailed financial advice to either party. Investment dealers are also involved as they must service their institutional and individual client needs by providing a continuous flow of advice and investment opportunities. Lawyers search titles, handle the details of financial transactions and sometimes find outlets for the savings of clients. Appraisers are frequently employed to place a value on the property being mortgaged.

Various levels of government are concerned with the mortgage market as well. Both the federal and provincial governments are committed to providing adequate and reasonably priced housing for their residents. The cost and availability of mortgage funds has a substantial impact on the amount and price of housing. Governments are also concerned with cyclicality of the construction industry in general and of housing construction in particular. This cyclicality is often traced to the operation of the mortgage market. In an effort to direct the mortgage market toward specific ends, governments have introduced a number of programs including direct loans, subsidies, mortgage insurance and the creation of new institutions. Some of these programs will be outlined in this book.

CONTENTS OF THE BOOK

Chapters 2 and 3 provide an overview and a technical base for the remainder of this study. Chapter 2 outlines the nature of the demand for mortgages and the activities of Canada's largest suppliers of mortgage loans. In Chapter 3 the investment characteristics of mortgages, namely maturity, risk, liquidity and yield, are discussed in detail.

Chapters 4 through 9 are concerned with the process of mortgage origination. The steps involved in the actual origination are illustrated in Chapter 4, and this is followed by detailed discussions of the role of mortgage insurance in Chapter 5 and the role of second mortgages in Chapter 6. Chapter 7 deals with the need for mortgage loans considered from the viewpoint of the borrower while Chapter 8 outlines the process by which borrowers and lenders are brought together. Chapter 9 contains a discussion of the detailed procedures followed by mortgage originators.

In Chapter 10 the lending operations of CMHC and the Ontario Housing Corporation are reviewed while Chapters 11 through 16 look at mortgages as investments from the point of view of a variety of financial institutions. The evolving secondary market is considered in Chapter 17. Finally, Chapter 18 provides both a summary of the book and a discussion of some issues that still face the market.

Chapter 2

The Demand for and the Supply of Mortgage Funds

Mortgage loans are required primarily for the purchase of new and existing housing. In 1974 financial institutions, excluding credit unions, originated $2.9 billion in mortgage loans for new housing, $3.1 billion for existing housing, and $1.2 billion for non-residential property. The demand for mortgages is derived from the demand for housing which, in turn, is a function of demographic characteristics; mobility, income, and tastes of the populace; cost and availability of housing and credit; and direct intervention of governments. The supply of mortgage funds depends on the total amount of funds made available by savers and the strength of competing demands for credit on the part of the personal, business, and government sectors of the economy.

The objective of this chapter is to provide an overview of the demand for and the supply of mortgage funds for residential housing with particular emphasis on the role of financial institutions.[1]

DEMAND FOR MORTGAGE FUNDS

Demographic Aspects of Housing Demand

A *household* is an occupied dwelling unit. The number of households formed (i.e. the demand for housing) depends on various factors of which demographic characteristics of the population are most important.

A recent demographic study done by Statistics Canada has reached a number of conclusions, some of which will be summarized here.[2] The study employed a

1. A number of econometric models have been created to study the Canadian economy. Most of these models have a simplistic institutional sector. A model of the mortgage market which contains a substantial institutional sector is discussed in a study by L.B. Smith and G.R. Sparks, *Institutional Mortgage Lending in Canada 1954-1968: An Econometric Analysis*, Ottawa: Bank of Canada, 1973.

2. *Population Projections for Canada and the Provinces, 1972-2001*, Ottawa: Statistics Canada, June 1974.

common method of population projection called the component approach. Under this approach, each factor influencing the population — mortality, fertility, and migration — is projected separately and applied to a base population to generate a projected population.

Life expectancy in Canada has risen steadily from 60 years for males and 62.1 years for females in the 1930's to 70.2 and 77.2 years respectively in 1971 and is projected to be 71.2 and 79.5 years respectively by 1986. The fertility rate[3] has grown from a low of 2.64 births in the 1930's to a high of 3.95 in 1959. Since that time it has fallen steadily to a level of 2.2 in 1971. Projected fertility rates are anticipated to remain quite low until 1976 and then to rise only slightly. This implies a lower rate of population growth than in the past. There is an increasing tendency towards families of two rather than three children. Immigration is the most volatile component of population change since it depends on economic, social and political conditions in both Canada and other countries. Immigrants have historically settled more heavily in British Columbia and Ontario and favored urban rather than rural areas. Emigration has been stable over the past several decades and has come disproportionately from Ontario, Quebec and New Brunswick. On balance, migrants within Canada have preferred to move to Ontario, Alberta and British Columbia from the other provinces.

Based upon reasonable assumptions, Statistics Canada anticipates that the population of Canada will grow relatively rapidly over the period 1976-1981 and then more slowly until the end of the century. Estimates of population in the year 2001 vary from 28.4 to 34.6 million, compared with 21.6 million in 1971.

Perhaps the most striking demographic characteristic is how the age distribution of the population has changed, and is expected to change over the next several decades. Table 2-1 points out the tremendous impact of the "baby boom" that followed World War II. One can see that there is a bulge in the number of persons entering certain age groups. This bulge is currently in the 25-29 year old age group, a prime period for house purchase. The table also shows that the bulge is followed by a severe decline in the number of persons in certain age groups. This decline is currently affecting the five to nine year old age group. Finally, there is expected to be a secondary effect of the baby boom beginning with the zero to four year old age group in the 1976-1981 period.

Table 2-2 demonstrates that certain patterns have developed in the types of dwellings constructed in the last two and one-half decades. Following a substantial increase after World War II, family formation grew modestly through the first half of the 1950's. Construction of both single family and multiple family dwellings increased moderately. Although subject to cyclical influences, the late 1950's and early 1960's saw apartment construction grow at a more rapid pace than single family dwelling construction. One may speculate that this tendency

3. The fertility rate is the number of children born to a female during her reproductive life.

Total Population Change Over Five Year Spans by Selected Age Group, For Canada (thousands)

Table 2-1

Age Group	1951-1956	1956-1961	1961-1966	1966-1971	1971-1976*	1976-1981*	1981-1986	1986-1991*	1991-1996*	1996-2001
0-4	262	273	-59	-520	-30	410	231	-51	-113	37
5-9	409**	272	221	-5	-425	-29	410	230	-49	-114
10-14	304	421	237	238	-49	-424	-30	409	230	-50
15-19	104	270	405	260	214	-48	-423	-30	408	230
20-24	41	56	278	425	286	218	-47	-421	-28	406
25-29	67	11	33	368	371	286	217	-48	-416	-29
30-34	174	56	-30	93	307	366	286	216	-45	-416
35-39	115	157	16	3	43	305	364	284	215	-46
40-44	157	94	137	6	-9	43	303	360	282	-214
45-49	34	137	83	41	3	-7	39	297	357	276
50-54	70	130	123	66	153	5	-6	42	291	347
55-59	59	77	119	130	55	148	5	-5	42	279
60-64	19	59	73	121	119	55	141	4	-4	40
65-69	31	2	36	99	83	108	53	129	4	-4
70-74	56				74	74	102	49	111	2
75-79	39				36	63	62	81	41	90
80-84	20	115	98	122	12	34	47	47	59	29
85-89	9				9	14	21	29	29	35
90 PLUS	3				8	8	12	16	18	17

* Projected based on medium fertility rates and migration assumptions.
** Underlined numbers indicate the impact of the "baby boom".

Source: Statistics Canada, *Population Projections for Canada and the Provinces,* June 1974.

toward apartment living was related to factors such as the movement of persons from rural to urban areas, young people leaving home at an earlier age, and the tendency of senior citizens to leave home and set up their own households. For those who desired single family housing but found the rising house prices too high, rental housing was a second choice. In 1965, apartment starts exceeded single family dwelling starts for the first time. From 1966 to 1971, non-family household formation grew at a more rapid pace than family household formation and the age of the head of the household declined dramatically, perhaps reflecting the impact of the post war baby boom. This led to an accelerated growth in the number of apartment starts. In the 1970's, in spite of a declining overall birth rate, a large number of households began having their first or second child. This factor, as well as generally rising incomes associated with a healthy economy, redirected demand toward single family dwellings. In 1974 apartment starts fell drastically, reflecting high interest rates, uncertainty over future rates of inflation, and the possible imposition of rent controls.

Dwelling Starts* in Canada by Type of Dwellings, 1950-1974
(Dwelling Units in Thousands)

Table 2-2

Year	Single Detached	Semi Detached and Duplex	Row	Apartment and Other	Total
1950	69	9	1	15	94
1951	53	6	—	10	69
1952	61	5	—	17	83
1953	71	7	1	24	103
1954	79	6	1	27	113
1955	99	11	2	27	139
1956	91	9	2	25	127
1957	83	9	2	28	122
1958	105	11	2	47	165
1959	92	10	2	37	141
1960	67	10	2	30	109
1961	76	12	2	36	126
1962	74	11	4	41	130
1963	77	8	4	60	149
1964	77	9	5	75	166
1965	75	8	5	78	166
1966	71	7	5	52	135
1967	73	10	7	74	164
1968	75	10	8	103	196
1969	78	10	11	111	210
1970	71	11	17	92	191
1971	98	14	16	106	234
1972	116	14	17	104	251
1973	132	13	17	106	268
1974	122	11	15	74	222

* A start, according to Statistics Canada, is recorded if "the concrete has been poured for the whole of the footing around the structure", Statistics Canada, *Housing Starts and Completions,* November 1973, P. 6.

Source: CMHC, *Canadian Housing Statistics,* various issues.

What are the future implications for household formation of Canada's changing population characteristics?[4] First, population will continue to increase over the next decade and, although demand for housing will remain strong, its growth is unlikely to be as dramatic as experienced in recent years. Second, an increased life expectancy coupled with a lower birth rate means that the population is aging. This implies a possible further shift toward institutional, multiple family and rental dwellings as opposed to detached single family accommodation. Third, by 1985, as the baby boom group ages, household formation will increase at a lower rate as a relatively small proportion of the population reaches the age where they would normally leave home or get married. This may be followed by another mini-housing boom by 1995. Immigration, although unpredictable, has two substantial impacts on housing demand. When immigrants arrive, they form households almost immediately, thus boosting demand. In addition, their affinity for urban areas means that the demand is centered in the cities. Migration patterns within Canada would suggest that demand in Ontario, Alberta and British Columbia will increase at a faster rate than the rest of the country. Movement from rural to urban areas in all provinces will mean that the pressure for increased housing will continue to be strongest in the cities.

Other Aspects of Housing Demand

Although demographic factors are important, there are a number of other factors which have an impact on housing demand including, personal real income, prices and credit conditions. Because the latter aspects of housing demand have been discussed in much detail elsewhere, the following merely provides a brief review.[5]

An increase in real income has a number of impacts. First, it may cause a family to leave a household previously occupied by two or more families (a process sometimes called *undoubling*). Second, it may lead to the departure of young or older people from the home to set up their own household. Third, it may cause families to leave rental housing in favor of owner occupied housing.

The cost of housing relative to other items influences the demand for housing. If housing becomes relatively less costly, the undoubling activity mentioned above, tends to occur. Furthermore, the cost of owning a home relative to the rental cost influences the demand for ownership versus rental accommodation.

Housing is considered an investment by a substantial number of people. Because ownership of property is a hedge against inflation and capital gains on a residence are tax free, property is an attractive investment and the demand for owner occupied versus rental property is increased.

4. For a more detailed discussion of this question, see John S. Kirkland, *Demographic Aspects of Housing Demand to 1986*, Ottawa: CMHC, December 1971.

5. Discussions of the demand for housing are found in: Wolfgang M. Illing, *Housing Demand to 1970*, Ottawa: Queen's Printer, 1965; L.B. Smith, *The Postwar Canadian Housing and Residential Mortgage Markets and the Role of Government,* Toronto: University of Toronto Press, 1974; and L.B. Smith, *Housing in Canada,* Ottawa: CMHC, 1971.

The final major factor influencing demand is credit conditions. As will be seen in later chapters, lenders use a variety of devices to allocate available funds including interest rates, loan to value ratios, income to payment ratios and amortization periods.

Mortgage Demand

The demand for mortgage loans on rental properties differs from the demand for mortgage loans on owner occupied dwellings.

In the case of a rental property, it is useful to think of an entrepreneur who intends to rent a building to tenants in order to make a profit. Rental revenue depends on the available stock and price of competing forms of accommodation. Costs include real estate taxes, interest charges, maintenance, heat, light, power, management and advertising. His objective is to earn a reasonable rate of return on the equity invested in the project. Any increase in operating or interest costs which could not be offset by an increase in rental income would tend to make the investment less desirable. In fact, rents tend to increase more slowly than house prices and, in some parts of Canada, the establishment or threat of rent controls has made apartment rental uneconomical. As can be seen in the hypothetical, yet realistic, case in Table 2-3, a shift in the interest rate of as little as one or two percent could destroy the viability of the project due to the high leverage involved. Econometric studies conducted by Lawrence Smith and others have indicated that the demand for mortgages for multiple family dwellings is more sensitive to the interest rate than the demand for mortgages on single family dwellings.[6] These results have been confirmed through discussions with lenders.

Illustration of a Hypothetical Rental Property Investment — **Table 2-3**

Rental Income	$ 630,000
Less Operating Costs	225,000
	405,000
Less Interest Expense	310,000
	95,000
Cost of Structure	$4,000,000
Less Mortgage at 10%	3,100,000
Equity	900,000

Return on equity before tax $\frac{95{,}000}{900{,}000} = 10.6\%$

6. For the model specifications and stock demand elasticities that were derived, see Smith, *Postwar Canadian Housing and Residential Mortgage Markets, Ibid,.*

The purchaser of a single family home views a mortgage somewhat differently. He is concerned about the initial down payment and closing costs on the one hand, and the monthly principal, interest and tax payments on the other. The borrower must determine the proportion of his total income which can be devoted to house payments after all other expenses are covered. In addition, lenders usually have guidelines limiting the proportion of gross income that can be taken up by principal, interest and tax payments. The permitted ratio is up to 30 percent but statistics indicate that the average actual ratio is frequently below 27 percent. The home buyer is not sensitive to the interest rate being paid *per se.* Instead, he reacts to the level of monthly payments and, as a result, changes in such mortgage characteristics as loan to value ratio, loan amount, amortization period and interest rate may have equal significance. Table 2-4 illustrates how monthly blended payments would vary with changes in the interest rate and amortization period for a $40,000 mortgage. It is common for lenders faced with a shortage of funds to make loans somewhat less attractive by increasing interest rates and shortening amortization periods.

Monthly Blended Mortgage Payments
Required to Repay a $40,000 Mortgage Assuming Various Interest Rates and Amortization Periods — **Table 2-4**

Interest Rate in Percent	AMORTIZATION PERIOD IN YEARS		
	20	25	30
8	331.36	305.30	289.90
9	355.68	331.20	317.14
10	380.68	357.80	345.08
11	406.40	385.20	373.60
12	432.40	412.80	402.80

Source: Financial Publishing Company, *Blended Payments for Loans,* Boston, Mass., 1964.

THE SUPPLY OF MORTGAGE FUNDS

General Determinants of Supply

The housing sector must compete with other sectors of the economy for financing. The availability of this financing depends on the total supply of funds and the strength of competing demands.

The monetary policy followed by the Bank of Canada is an attempt to influence the level of employment, economic growth, prices and Canada's balance of payments. A change in monetary policy affects various financial institutions to different degrees and some institutions are more active mortgage lenders than oth-

ers. As a result, the impact on housing of any change in monetary policy should be interpreted within an institutional context.[7]

The supply of funds for mortgage loans seems to be related to the business cycle.[8] When the economy is expanding rapidly, the business sector appears to bid funds away from residential construction so that, when the peak of a business cycle arrives, housing starts have already begun to turn down. Then, as the growth of the economy slows, more funds become available for housing. This observed cyclicality, of construction activity in general and housing starts in particular, has been of concern to both government and private industry.[9] A study conducted for the Economic Council of Canada has identified five periods since 1950 during which housing starts have declined substantially.[10] Since instability in housing starts appeared related to instability of the economy in general, the study was able to propose little in the way of specific remedies for housing.

Given the total funds available in the economy, the primary determinant of the supply of funds for mortgages is the investment characteristics of mortgages vis-a-vis other market investment opportunities. These investment characteristics, which are outlined in Chapter 3, include risk of default, yield, maturity and liquidity. In addition, there are a number of less quantifiable factors such as the relationship between the mortgage business of an institution and its other activities, the administrative structure of the mortgage lender and the attitudes of institutional portfolio managers toward mortgages.

Governments have become increasingly important in influencing the supply of funds for housing over the last two decades. Most provinces now have active and growing housing corporations. The federal government, through CMHC, has committed large amounts of money to housing in an effort to spur the economy and to make more housing available to certain segments of the population. In addition to direct financing, CMHC has influenced the supply of funds through changes in the regulations governing lending under the National Housing Act which have made mortgages a more desirable investment for some institutions.

7. For example, L.B. Smith and G.R. Sparks, "The Interest Sensitivity of Canadian Mortgage Flows," *Canadian Journal of Economics*, August 1970, concluded that life insurance company and chartered bank mortgage approvals are strongly influenced by monetary policy while trust and loan companies are influenced to a lesser, yet important degree.

8. For a good discussion of the cyclicality of Canadian housing starts, see D. Das Gupta, "Short Term Cycles in Residential Construction in Canada, 1951-1970," Ottawa: CMHC, 1974. This is an unpublished paper.

9. For representative positions by provincial governments, see "Ontario Wants Starts in Housing Stabilized at 100,000 Annually," *The Globe and Mail*, Toronto, January 22,1975, and "Isolation of House Financing from Money Market Urged," *The Globe and Mail*, Toronto, September 20, 1974.

10. Economic Council of Canada, *Toward More Stable Growth in Construction*, Ottawa: Information Canada, 1973.

Mortgage Holdings of Financial Institutions

As indicated in Table 2-5, chartered banks are Canada's largest financial institutions and are growing rapidly. While life insurance companies have traditionally been Canada's second largest financial institution, their growth has not been as rapid as most other institutions and they have been surpassed in dollar size by the estate, trust and agency (ET & A) accounts of trust companies. In the last five years, credit unions have expanded rapidly.

Assets of Major Canadian Financial Institutions, As of December 31, Selected Years* ($ billions) **Table 2-5**

	1963	1968	1973	1974**
Chartered Banks	22.1	36.7	79.8	97.1
Estate, Trust and Agency Account of Trust Companies	10.0	18.9	29.4	32.0
Life Companies	10.2	13.8	19.7	21.4
Trust Companies	2.3	5.0	10.5	12.7
Credit Unions	2.0	3.8	10.4	12.0
Loan Companies	1.5	3.0	5.9	6.8
Other Lending Institutions	0.6	0.8	1.0	1.1

*Pension funds are not explicitly included in this table although a large proportion of pension fund assets are to be found in the "E,T&A Account" totals. Estimated total pension fund assets in 1973 were $22.3 billion.
**Estimated.

Source: CMHC, *Canadian Housing Statistics*, 1974.

The proportion of assets devoted to mortgages varies among institutions and over time. Table 2-6 illustrates that chartered banks, pension funds and ET & A accounts devote a low proportion of their assets to mortgages; however, due to the large size and rapid growth of the institutions, they all have a substantial impact on the market. It is particularly noticeable that the proportion of trust company assets devoted to mortgages has been edging upward over the last decade. The reasons for these investment strategies of financial institutions are outlined in subsequent chapters.

Tables 2-7 and 2-8 provide data on the mortgage holdings of Canada's major financial institutions. The data include residential, commercial and industrial mortgages outstanding on both newly constructed and existing properties. A brief discussion of the evolution of mortgage lending by financial institutions in general over the last two and one-half decades will be undertaken at this point. A detailed discussion of institutional lending practices is reserved for later chapters.

Institutional Mortgage Lending 1953-1974

Following the Korean War, housing starts grew each year from 1951 to 1955.

Mortgage Holdings as a Percent of Total Assets
Selected Institutions, Selected Years

Table 2-6

	1974	1973	1968	1963
Loan Companies	83.2	80.4	75.1	76.9
Trust Companies	72.2	68.5	54.8	47.5
Life Insurance Companies	44.2	44.6	51.4	44.8
Credit Unions	34.2	32.4	29.4	28.6
Estate, Trust & Agency Accounts of Trust Companies*	11.6	11.5	11.4	10.7
Pension Funds**	N/A	9.4	8.6	9.2
Chartered Banks	6.2	5.7	2.9	4.0

* A substantial proportion of E,T & A account assets consists of pension funds.
** Source of these data is Statistics Canada, *Trusteed Pension Plans Financial Statistics*, various issues.

Source: CMHC, *Canadian Housing Statistics*, 1974.

This growth was fueled by an expanding economy and more liberal housing legislation. As of 1953, life insurance companies were the second largest financial intermediary behind banks but, because banks were not permitted to make mortgage loans, and life insurance companies devoted over 40 percent of their assets to mortgages, the latter held over 50 percent of all outstanding mortgage loans. In 1954, the National Housing Act (NHA) was substantially revised giving CMHC the power to create a new mortgage insurance plan and direct lending programs. Banks were allowed to make mortgage loans for the first time providing they were on new properties and were NHA insured. The immediate result was that in late 1954 and 1955, banks set up mortgage origination facilities and invested heavily in mortgages.

As the economy continued to expand into 1956, government and corporate borrowers put more pressure on the capital markets which resulted in financial institutions allocating their funds away from housing toward other public and private investments. This led to a decline in housing starts that persisted until 1958. Perceiving strong demand pressures in the economy, the monetary policy of the Bank of Canada was mildly contractionary in the first half of 1957. This policy further pushed institutions out of the mortgage market. At a conference in March of 1957, the Bank of Canada persuaded the chartered banks to originate a minimum of $150 million in new residential mortgage loans to ease some of the downward pressure on housing starts.

A sharp downturn in business activity in late 1957 was met with an easing of credit conditions and increased mortgage lending by banks in 1958. Late 1957 and 1958 were also marked by a heavy infusion of funds into the housing market by CMHC which began to be used as a significant instrument of government economic policy. Until 1958, CMHC had been used basically as a lender of last resort in areas where no loans were available through lending institutions. In the next decade, CMHC attempted to act as a stabilizing force in the housing market, entering the market with direct loans at times when the supply of funds from the

Mortgage Loans Outstanding by Various Investors, 1953-1974
($ millions)

Table 2-7

Year	Life Companies	Chartered Banks	Loan Companies	Trust Companies	Other Lending Institutions*	Corporate Lenders**	Credit Unions	Government & Government Agencies	Pension Funds	E, T, & A Funds of Trust Co.'s	Total
1953	1,402		352	149	33	49	155	768	—	—	2,908
1954	1,658	74	396	178	42	49	171	850	—	—	3,418
1955	2,016	294	444	228	43	66	211	868	—	—	4,170
1956	2,408	493	497	268	57	85	236	893	—	—	4,937
1957	2,660	586	521	275	70	114	262	973	—	—	5,461
1958	2,875	790	569	343	80	125	295	1,337	—	—	6,414
1959	3,140	968	629	409	88	326	341	1,681	—	—	7,582
1960	3,412	971	698	472	97	524	390	1,995	299	431	9,289***
1961	3,710	953	815	622	119	759	426	2,229	341	516	10,490
1962	4,142	921	989	845	144	989	479	2,410	414	653	11,986
1963	4,560	885	1,188	1,103	175	1,371	549	2,531	479	799	13,640
1964	5,094	846	1,492	1,449	210	1,642	622	2,823	542	1,061	15,781
1965	5,662	810	1,839	1,975	276	1,930	695	3,222	623	1,232	18,264
1966	6,248	778	1,949	2,169	310	1,998	883	3,879	676	1,399	20,289
1967	6,636	840	2,073	2,414	319	1,989	1,060	5,006	724	1,512	22,573
1968	7,107	1,057	2,235	2,727	335	2,068	1,105	5,732	776	1,662	24,804
1969	7,490	1,324	2,508	3,264	343	1,980	1,202	6,400	863	2,050	27,424
1970	7,723	1,481	2,868	3,829	382	2,052	1,353	7,221	1,022	2,188	30,119
1971	7,880	2,338	3,152	4,480	399	2,079	1,660	8,183	1,169	2,218	33,558
1972	8,145	3,543	3,749	5,462	387	2,186	2,391	8,865	1,296	2,586	38,610
1973	8,768	4,564	4,753	7,194	424	2,463	3,360	9,500	1,551	3,108	45,685
1974	9,500	6,025	5,655	9,170	450	2,800	4,100	10,300	1,800	3,400	53,200

* Includes Quebec savings banks, mutual benefit and fraternal societies.

** These data have been included for completeness but they should be interpreted guardedly since on three separate occasions the method of collecting the data was revised.

*** Since this is the first year that the holdings of Pension Funds and ET & A accounts are included, the large change in mortgage holdings cannot be given any significance.

Source: CMHC, *Canadian Housing Statistics*, 1974.

Changes in Mortgage Loans by Various Investors, 1954-1974
($ millions)

Table 2-8

Change During	Life Companies	Chartered Banks	Loan Companies	Trust Companies	Other Lending Institutions*	Corporate Lenders**	Credit Unions	Government & Government Agencies	Pension Funds	E, T, & A Funds of Trust Co.'s	Total Change
1954	256	74	44	29	9	0	16	82	—	—	510
1955	358	220	48	50	1	17	40	18	—	—	752
1956	392	199	53	40	14	19	25	25	—	—	767
1957	252	93	24	7	13	29	26	80	—	—	524
1958	215	204	48	68	10	11	33	364	—	—	953
1959	265	178	60	66	8	201	46	344	—	—	1,168
1960	272	3	69	63	9	198	49	314	299	431	1,707
1961	298	(18)	117	150	22	235	36	234	42	85	1,201
1962	432	(32)	174	223	15	230	53	181	73	137	1,496
1963	418	(36)	199	258	31	382	70	121	65	146	1,654
1964	534	(39)	304	346	35	271	73	292	63	262	2,141
1965	568	(36)	347	526	66	288	73	399	81	171	2,483
1966	586	(32)	110	194	34	68	188	657	53	167	2,025
1967	388	62	124	245	9	(9)	177	1,127	48	113	2,284
1968	471	217	162	313	16	79	45	726	52	150	2,231
1969	383	267	273	537	8	(88)	97	668	87	388	2,620
1970	233	157	360	565	39	72	151	821	159	138	2,695
1971	157	857	284	651	17	27	307	962	147	30	3,439
1972	265	1,205	597	982	(12)	107	731	682	127	368	5,043
1973	623	1,021	1,004	1,732	37	277	969	635	255	522	7,075
1974	732	1,461	902	1,976	26	337	740	800	249	292	7,515

*Includes Quebec savings banks, mutual benefit and fraternal societies.
**These data have been included for completeness but should be interpreted guardedly since on three seperate occasions the method of collecting the data was revised.
***Since this is the first year that the holding of Pension Funds and E.T.&A accounts are included the large change in mortgage holdings cannot be given any significance.

Source: Derived from Table 2-7.

private sector appeared to be low, and withdrawing when private supply was strong. The decline in competing demands for funds and active CMHC lending pushed 1958 housing starts to extraordinary levels which were not matched again until 1964.

Housing starts declined in 1959 and 1960 and interest rates generally drifted upward. The Bank Act did not allow chartered banks to make loans at an interest rate in excess of six percent and as the NHA mortgage rate rose above six percent in late 1959, banks withdrew from the market completely and did not return until 1967. In the ensuing years, this slack in supply was taken up by insurance, trust and loan companies and CMHC.

A new expansionary phase in housing starts began in 1961 and continued into 1965. This expansion was supported by available funds from the private sector, direct loans from CMHC and a winter house building incentive initiated by the federal government in 1963 through 1964.

The economy expanded strongly throughout 1965 and 1966 causing an increase in prices and pressure on available resources. This was met by a slowdown in the growth of the money supply in the first half of 1966 and an ensuing "credit crunch". The failure of Atlantic Acceptance Corporation, a sales finance company, in mid-1965, along with tight credit conditions, forced trust and loan companies to reduce their level of mortgage originations drastically in 1966. In addition, the introduction of the Canada and Quebec pension plans had a moderating impact on the growth of insurance companies who were traditional mortgage lenders. These factors contributed to a sharp drop in housing starts in 1966.

From 1967 to 1969, housing starts grew steadily. This was assisted by a 1967 revision in the Bank Act which removed interest ceilings on bank loans. In the same year, chartered banks were permitted for the first time to make conventional mortgage loans for both new and existing housing. Faced with increasing bank and near-bank competition and provincial usury laws that made it difficult for them to compete, credit unions reduced their rate of mortgage origination significantly. An amendment to the NHA in 1969 permitted lenders, at their option, to issue five year term NHA insured mortgages. This made mortgages more attractive to some lenders, particularly trust companies.

The monetary restraint begun in 1969 in an effort to combat inflation, continued into 1970, causing a levelling of mortgage lending that was offset, to some extent, by increased government lending activity. Following an economic slowdown in 1970, monetary policy became expansionary and mortgage lending by all deposit-taking institutions increased rapidly. As a result, by 1973 mortgage lending reached record levels. This growth was assisted by the creation of private mortgage insurance companies and legislation permitting high ratio loans.

In 1974, interest rates rose to record levels and many institutions shortened the maturity structures of their portfolios. The shortage of funds, and a sharp reduction in effective demand by renters and owners, accentuated by the liquidation of

speculative holdings of houses and condominiums, resulted in lower mortgage originations.

Mortgage Lending By The Personal Sector

Although the emphasis in this book is on the institutional sources of mortgage funds, it should be recognized that a substantial proportion of funds going into housing comes from the personal sector. In the purchase of newly constructed dwellings, at least five percent (and usually more) of the funds are derived from owners equity and additional funds, in the form of second mortgage loans, may be supplied by individuals and finance companies. Mortgage loans made by the personal sector are quite common in the purchase of existing housing. Vendors often take back a mortgage to assist the sale and members of families frequently loan funds to each other to purchase a home. In addition, professional persons acting through lawyers and brokers provide substantial amounts of mortgage funds.

While data on lending by the personal sector are scarce, statistics supplied by the Ontario Statistical Centre provide an insight into the dimensions of this activity.[11] Table 2-9 shows the total value of all conventional mortgages with a value below $500,000 issued in Ontario in the last five years. Using $500,000 as the cut-off point captures all residential mortgages and some commercial and industrial mortgages as well. From the table, it can be seen that the size of the personal sector is impressive although the proportion of loans financed by this sector has gradually declined as credit unions and banks have become more competitive.

Funds For New and Existing Housing

Table 2-10 shows loan approvals for new and existing residential property and other property by selected institutions. CMHC has traditionally devoted most of its efforts to new housing but began in 1965 to make and insure loans on existing properties as well. As discussed earlier, banks were not permitted to make mortgage loans on existing or non-residential properties until 1967. At present, banks still make a proportionately small amount of mortgage loans on non-residential properties but they have become a major supplier of loans on existing residential properties. While life insurance companies have traditionally been major lenders for newly constructed residential properties, the relative attractiveness of long-term mortgages and the availability of equity participation have caused them to shift toward non-residential mortgage loans. Trust and loan companies have typically originated mortgage loans on both new and existing property.

A striking feature of Table 2-10 is the rapid increase in loans on existing as opposed to new properties over the last decade and a half. This substantial demand for mortgage loans on existing property reflects three factors. First, the

11. The Ontario Statistical Centre is part of the Ministry of Treasury, Economics and Intergovernmental Affairs of the Province of Ontario.

**Total Value of Conventional Mortgages Issued in Ontario,
Each Having A Value of Less Than $500,000 by Type of Lender, 1969-1973** **Table 2-9**

	1969		1970		1971		1972		1973	
	$ millions	Percent	$ millions	Percent	$ millions	Percent	$ millions	Percent	$ millions	Percent
Personal Sector	1,455	47.7	1,186	46.9	1,255	38.6	1,504	35.0	2,055	32.0
Lending Institutions*	755	24.9	662	26.2	959	29.5	1,299	30.2	2,179	33.9
Financial Corporations	187	6.2	110	4.4	131	4.0	204	4.7	286	4.5
Other Corporations	358	11.8	279	11.0	378	11.6	419	9.7	671	10.4
Benevalent Societies	6	0.2	4	0.2	7	0.2	7	0.2	9	0.1
Public Sector	110	3.6	87	3.4	106	3.3	209	4.9	198	3.1
Chartered Banks	127	4.2	138	5.5	293	9.0	443	10.3	761	11.9
Credit Unions	42	1.4	62	2.4	125	3.8	215	5.0	263	4.1
All Lenders	3,030	100.0	2,528	100.0	3,254	100.0	4,300	100.0	6,422	100.0

* Primarily insurance, trust and loan companies.

Source: Government of Ontario, Ministry of Treasury, Economics and Intergovernmental Affairs, *Realty Mortgage Loans Registered in Ontario,* Various Years.

increasing mobility of Canada's population is leading to a rapid turnover in ownership of existing housing and although a purchaser may take over the old mortgage, it is more often the case that, due to rising prices, the old mortgage is repaid and a new one created. Second, homes are sometimes used as collateral for loans for purposes such as investment or college education. Third, there is a general desire to upgrade one's living accommodation from less costly to more costly housing.

Funds for Single Family and Multiple Family Housing

As indicated in Table 2-11, CMHC emphasized single family loans from 1957 to 1966. After 1966, the policy of the corporation shifted to funding housing for groups such as university students, the aged, and persons on low incomes. Chartered banks have traditionally made loans for single family dwellings but as the demand for multiple family dwellings increased and bank expertise developed, they began to make a larger dollar volume of multiple family loans. Insurance, trust and loan companies have historically had the expertise and policy of making loans on both single and multiple family properties.

Loans Approved for New & Existing Housing & Other Property by Source, 1957-1974
($ millions)

Table 2-10

Period	CMHC	Chartered Banks	Life Insurance companies	Trust Companies	Loan Companies	Other Companies	Total
New Residential Construction							
1957	233	173	251	37	44	12	750
1958	373	300	352	67	74	16	1,183
1959	343	175	351	64	53	6	994
1960	161	1	378	88	73	8	710
1961	273	—	494	190	83	18	1,059
1962	187	—	532	199	107	24	1,049
1963	320	—	616	250	151	20	1,357
1964	397	9	647	273	193	42	1,561
1965	467	6	690	316	156	54	1,689
1966	537	—	459	144	120	42	1,302
1967	674	127	494	302	137	40	1,775
1968	443	332	614	528	222	98	2,238
1969	547	284	378	650	267	109	2,237
1970	901	379	177	544	200	96	2,298
1971	676	851	353	742	402	123	3,120
1972	442	1,026	414	908	528	130	3,448
1973	382	1,223	588	1,244	556	101	4,094
1974	581	1,004	400	868	547	61	3,461
Existing Residential Property							
1957	—	—	57	37	46	9	149
1958	—	—	79	55	63	11	208
1959	—	—	95	55	57	9	216
1960	—	—	79	58	70	14	221
1961	—	—	103	85	89	23	300
1962	—	—	118	106	109	25	358
1963	—	—	126	156	123	25	430
1964	—	—	164	243	189	43	640
1965	21	—	198	296	211	45	748
1966	19	—	126	191	132	21	471
1967	42	102	135	251	151	17	655
1968	49	96	73	256	132	15	572
1969	59	81	54	354	153	30	678
1970	30	114	39	347	185	38	725
1971	37	253	74	612	385	36	1,364
1972	31	461	109	744	527	53	1,896
1973	59	965	154	1,505	567	67	3,317
1974	238	899	161	1,284	663	67	3,312
Other							
1957	—	—	70	8	25	1	104
1958	—	—	99	20	55	1	174
1959	—	—	130	28	58	—	216
1960	—	—	131	46	85	2	263
1961	—	—	140	60	96	3	298
1962	—	—	135	98	77	1	311
1963	—	—	160	115	95	3	373
1964	—	—	200	180	124	3	507
1965	—	—	269	197	114	1	581
1966	—	—	219	88	74	1	382
1967	—	24	171	109	63	2	369
1968	—	17	158	114	44	1	335
1969	—	16	189	172	54	1	432
1970	—	16	240	189	62	—	508
1971	—	61	423	249	114	—	847
1972	—	148	519	214	223	—	1,104
1973	—	206	729	383	200	—	1,518
1974	—	131	611	251	178	—	1,171

Source: CMHC, *Canadian Housing Statistics*, 1974.

Funds Provided for New and Existing Residential Property by Source and Type of Dwelling, 1957-1974 ($ millions) — **Table 2-11**

	CMHC		Chartered Banks		Life Insurance Companies		Trust Companies		Loan and Other Companies		Total		Grand Total
	Single	Multiple	Single	Multiple	Single	Multiple	Single	Multiple	Single	Multiple	Single	Multiple	
New Residential Construction													
1957	179	57	169	4	164	87	29	8	32	25	573	181	754
1958	310	79	284	17	213	140	48	17	46	44	901	297	1198
1959	322	45	169	7	204	148	34	30	32	27	761	257	1018
1960	149	26	1	—	244	184	61	27	45	36	500	224	724
1961	226	62	—	—	317	178	128	62	51	50	721	352	1074
1962	152	47	—	—	324	209	124	75	56	75	656	406	1062
1963	254	83	—	—	309	307	142	108	79	92	784	590	1374
1964	312	113	—	9	252	395	118	155	102	134	784	806	1590
1965	368	128	—	6	251	439	141	175	91	119	851	867	1718
1966	402	180	—	—	207	252	73	71	81	82	763	585	1348
1967	373	341	94	34	182	312	92	210	73	104	813	1002	1815
1968	196	275	275	58	198	415	188	340	128	193	985	1281	2266
1969	123	347	221	63	146	232	315	335	163	214	958	1191	2159
1970	150	728	227	149	79	98	239	295	122	166	816	1437	2253
1971	123	558	536	313	112	239	320	406	299	286	1390	1802	3192
1972	99	380	662	359	178	232	415	470	362	293	1716	1719	3435
1973	109	331	804	413	271	309	625	600	407	245	2215	1861	4076
1974	200	408	707	289	240	158	556	297	446	159	2149	1311	3460
Existing Residential Properties													
1957	—	—	—	—	44	13	35	2	38	17	117	32	149
1958	—	—	—	—	57	22	50	5	51	22	157	50	207
1959	—	—	—	—	67	28	46	10	45	21	158	59	217
1960	—	—	—	—	63	16	50	8	53	31	166	55	221
1961	—	—	—	—	75	29	70	15	70	41	215	85	300
1962	—	—	—	—	84	34	90	16	83	52	257	103	360
1963	—	—	—	—	82	44	128	28	94	54	304	126	430
1964	—	—	—	—	99	65	197	46	149	84	444	196	640
1965	—	22	—	—	135	63	233	63	172	83	540	231	771
1966	—	19	—	—	102	24	163	28	109	45	373	117	490
1967	33	9	96	6	99	36	219	31	126	41	573	123	696
1968	33	17	90	6	53	21	216	40	106	40	498	124	622
1969	40	13	77	4	41	13	302	52	127	56	587	138	725
1970	24	5	110	4	26	13	298	49	152	71	609	143	752
1971	25	7	233	20	49	25	534	77	324	96	1165	225	1390
1972	24	7	426	35	67	43	661	83	457	124	1636	293	1929
1973	42	11	888	78	97	57	1323	182	478	156	2828	484	3312
1974	161	72	775	124	112	50	1119	165	561	170	2728	581	3309

Source: CMHC, *Canadian Housing Statistics*, 1974.

Chapter 3

The Investment Characteristics of Mortgages

Financial markets allocate available savings to ultimate users directly or through financial intermediaries.[1] A firm or individual wishing to purchase a property taps these savings by issuing a mortgage against the property. The attractiveness to investors of the mortgage as opposed to other available investments depends on its perceived maturity, risk, liquidity and yield characteristics. The investment characteristics of mortgages have evolved over time in response to borrower and lender needs, regulatory constraints, government policies and institutional preferences. The objective of this chapter is to examine these investment characteristics and how they have evolved. When mortgages are traded in large blocks, they may take on added investment features depending on institutional practices. A discussion of the features of blocks of mortgages is deferred to Chapter 17 which deals with the secondary mortgage market.

MATURITY OF MORTGAGES

Overview

When a mortgage debt is created, the lender and borrower agree on a date by which the entire amount of the principal and interest must be paid. The period of time from the creation of the debt to this *maturity date*[2] is called the *term* of the mortgage. In some cases, the borrower pays periodic interest payments and repays the entire principal at maturity. In most cases, however, the borrower makes monthly payments consisting of interest and a partial repayment of principal. This method of instalment payment is referred to as *amortization* of the mortgage. If the periodic payments are equal in amount for the amortization period, they are called *blended payments.* Monthly mortgage payments usually include an amount equal to one-twelfth of annual property taxes.

1. For a general review of the functioning of capital markets, see J.C. Van Horne, *The Function and Analysis of Capital Market Rates*, Toronto: Prentice Hall, 1970.

2. For a discussion of this and other definitions, see Ontario Mortgage Brokers Association, *Ontario Mortgage Brokers Association Manual,* Toronto, n.d.

This section examines the terms and amortization periods which are commonly available in the mortgage market. The Interest Act (Canada), the National Housing Act and the portfolio requirements of financial institutions are the major factors to be considered.

The Interest Act (Canada)

The Interest Act specifies that if the original term of a mortgage is greater than five years, the entire principal amount of the mortgage outstanding may be paid at any time after the expiration of five years. This payment must be accompanied by three months interest in lieu of notice. The phrase, "in lieu of notice" has been interpreted to mean, "whether notice is given or not". This prepayment privilege does not apply to corporate borrowers.[3]

The implication of the Interest Act from the lender's standpoint is that for all mortgages originated with non-corporate borrowers, the term of the mortgage can only be regarded as certain for a maximum of five years, regardless of the term set out in the mortgage document. While the lender is committed to the contract for the full term, the borrower may repay his mortgage in full after five years even if the term is 25 years. The Act also implies that a corporate borrower may be committed to a term of longer than five years if the borrower and lender both agree.

Conventional Mortgages

A conventional mortgage may have any term or amortization period agreed upon by the lender and borrower and is only subject to the Interest Act (Canada) as discussed above. Nonetheless, certain institutional practices have evolved. The typical single family conventional mortgage may have an original term of five years and amortization period of 20-25 years or an original term equal to the 20-25 year amortization period. Banks and trust companies prefer the former arrangement and insurance companies have traditionally favored the latter, although their attitude is changing. Mortgages on rental properties may be for a fixed term of 25-35 years.

Although partial prepayment privileges are often granted as part of the mortgage agreement, it is uncommon, except for compassionate reasons, to allow a mortgage to be repaid within five years without penalty. The only common exception to this rule occurs during periods of very high interest rates when some lenders actively encourage borrowers to prepay outstanding mortgages bearing low interest rates. For example, in 1974, Imperial Life Assurance Company of Canada wrote letters to its clients giving them the opportunity to prepay low interest rate mortgages without a penalty and, in some cases, with a discount.

If a high ratio single family mortgage is granted and insured by one of the private insurance companies, the terms are influenced by any regulations imposed

3. *Interest Act*, (1970) R.S.C. 1970, c. 156, s. 10(1).

by the insurance company. Private mortgage insurance companies are willing to insure loans with an amortization period of up to 30 years for new construction and 25 years for existing construction but the term of the loan may be shorter. These limits are not considered to be constraining since the typical amortization period is 25 years or less.

The National Housing Act

In general, mortgages are subject to the Interest Act unless they are issued under the provisions of the National Housing Act.

Until 1969, the term of mortgage loans insured under the National Housing Act always equalled the amortization period. Under this *Term-Equals-Amortization plan,* the term of single family mortgages was usually 25 years but could be as high as 40 years. On rental loans, the maximum term was also 40 years. Financial institutions still hold many of these longer term mortgages in their portfolios.

In 1969, the Regulations of the National Housing Act were revised to permit loans to be made at the lenders' option for a minimum term of five years. The amortization period on such loans remains from 25 to 40 years, with 25 years a common practice.[4] At the end of five years the remaining principal is due and payable. The lender then has the option to renew the mortgage for another five year term or demand repayment. The insurance remains in force without an additional insurance fee for any renewal as long as the new term plus the original five years does not exceed a total of 40 years.[5] Although there is no legal obligation to renew at the end of five years, lenders feel a strong obligation to renew as long as they can obtain the then prevailing interest rate and the account is in good standing.

In the case of all NHA loans made to homeowners, whether five year term or not, the homeowner has the right to prepay up to 10 percent of the original amount of the loan at the time of the 12th monthly payment, another 10 percent at the time of the 24th monthly payment, and all or part of the outstanding balance on any monthly anniversary after the 36th monthly payment. The 10 percent features are not cumulative. In the event that the borrower decides to prepay portions of the loan, the lender can ask for a three month interest bonus on the amount of prepayment.

Rental project loans under the NHA may have a five year term but there is no right of partial prepayment within that period. If a rental loan is made to a

4. In 1974, almost 85 percent of all NHA mortgages extended by approved lenders on new single family dwellings had an amortization period of 25 years.

5. This feature also applies to privately insured mortgages with the proviso that the insurance contract for residential properties is for 20 years and covers the original five year term and three renewals, and the amortization period used on renewals is not to exceed the amortization period approved when the insurance was originally placed in force.

corporate borrower, the lender may extend the period within which prepayment may not be made up to within 10 years of the expiration of the amortization period. This is normally referred to as the *lock-in period.* For example, on a loan with an original term of 40 years, the period during which prepayment may not be made can be up to 30 years. After that time, prepayment may take place upon payment of a three months interest penalty.

As indicated in Table 3-1, the new five year term mortgages allowed under the National Housing Act have become very popular. Over 95 percent of all NHA mortgages issued through approved lenders for owner occupied housing in 1974 were of this type. As might be expected, trust companies find this an attractive investment because of the five year term of many of their liabilities. Chartered banks have also shown a preference for the five year term. However, life insurance companies prefer longer term assets corresponding with the nature of their liabilities. They have also shifted more heavily into rental mortgages where the five year term is less common.

Renegotiable Term Mortgages as a Percent of All Mortgages Originated by Various Institutions Under the NHA, 1971-1974* **Table 3-1**

Lender	1971	1972	1973	1974
Chartered Banks	91.5	94.7	99.5	99.5
Life Insurance Companies	32.6	29.0	33.1	51.3
Trust Companies	99.0	99.8	99.8	98.4
Mortgage Loan Companies	96.9	94.0	99.5	99.9
Other Companies**	59.8	92.0	99.6	100.0
Total, Approved Lenders	90.2	91.1	95.3	95.8
CMHC Direct Loans	79.0	86.5	91.1	96.8
Grand Total	88.1	90.6	94.6	95.8

* Data are for home-ownership occupancy only.
** Includes Quebec Savings Banks, mutual benefit and fraternal societies.

Source: CMHC, *Canadian Housing Statistics,* various issues.

During the 1974 election campaign, the Liberal Party proposed that home buyers be given the legal right to prepay their mortgages without penalty during the first five years of the mortgage agreement. This proposal was not well received by investors who felt that it would reduce the attractiveness of mortgages.[6] Since that time, the proposal appears to have been dropped.

6. "Prepayment Proposal Felt Threat to Mortgage Stability," *The Globe and Mail,* Toronto, June 26, 1974.

Second Mortgages

If a second mortgage is held or *taken back* by the seller of a house, it may have almost any term and amortization period. The most common practice is for the mortgage to be fully open to prepayment, often without notice or bonus. The vendor often sells the second mortgage at a discount to a financial institution. In this case, the financial institution stands to obtain an even higher yield if the mortgage is prepaid; it is willing, therefore, to permit prepayment without notice or bonus. Some vendors have been known to issue second mortgages which are long-term and find it impossible to resell them except at a substantial discount.

Second mortgages granted by large national firms, such as Canadian Acceptance Corporation or Traders Homeplan Ltd., would commonly offer a five year term and 20 year amortization period although other options are available. If all appraisal and legal fees are paid by the mortgagor the mortgage is usually fully open. However, if the mortgagee pays substantial origination costs he tends to make the mortgage closed for one or two years. In any event, when a mortgage is prepaid a three months bonus is exacted.

THE YIELD ON MORTGAGES

Overview

The yield available from a mortgage investment is not as straight forward as the yield on other debt types of securities. This section examines the various yields available in the mortgage market, how these yields compare to alternative investments, and some of the factors affecting mortgage yields. To provide perspective, it should be noted that mortgages have to be serviced and a fee of one-tenth of one percent for rental properties and between three-eighths and one-half of one percent for single family properties is charged and must be deducted from the gross yields. Table 3-2 provides an overview of several of the types of mortgages which will be presented in this chapter. A discussion of yields available on blocks of mortgages traded in the secondary market is contained in Chapter 17.

Computing the Yield

It is useful to understand the computations underlying the monthly mortgage payments provided by a standard mortgage amortization table.[7] According to the Interest Act, a mortgage agreement employing blended payments must specify the

7. See, for example, *Monthly Payments for Mortgage Amortization,* Boston, Mass.: Financial Publishing Company, n.d. The author recognizes that this section on computing the yield is dealt with in a very brief fashion. For a more detailed examination, see H. Woodard, *Canadian Mortgages*, Toronto: Collins Publishing, 1959, pp. 192-210.

The A.E. LePage "Mortgage Bulletin", Describing the Toronto Mortgage Market as of April 15, 1974 — **Table 3-2**

Classification	Interest Rate (%) April, 1974	Interest Rate (%) March, 1974	Availability of funds
Direct Government Lending			
1. CMHC — NHA Sec. 58	9½	(9½)	Direct loans to homeowner applicants.
2. CMHC — NHA Sec. 15	8	(8)	Federally subsidized loans to low rental housing.
3 OHC			
(a) HOME Plan	8¾	(8¾)	Funds for homes on leasehold HOME lots.
(b) Preferred Lending	8¾	(8¾)	Funds for homes on leasehold lots built under HOME plan price limitations.
NHA Approved Lenders			
4. Housing — New & Resales	10½-11	(10)	Ample supply.
5. Apartments & Townhouses	10½-11	(9¾-10)	Good supply of funds, demand remains light.
6. Condominium Apartments & Townhouses	10¾-11¼	(10-10¼)	Funds in short supply.
Conventional			
7. Apartments & Townhouses	10½-11	(9¾-10)	Fair supply.
8. Condominium Apartments & Townhouses	10¾-11¼	(10-10¼)	Funds in short supply.
9. Housing — new and resales	10½-11	(10-10¼)	Good supply.
10. Housing — builders loans	11	(10)	Adequate Supply
11. Shopping Centres—Commercial, Industrial			
(a) Major leases or covenants	10½-10¾	(9¾-10)	Reasonable supply.
(b) Non-major leases or covenants	10¾-11½	(10-10¼)	Funds will be in short supply for speculative development.
12. Office Buildings			
(a) Major leases or covenants	10½-10¾	(9¾-10)	Funds available for well located, pre-leased developments.
(b) Non-major leases or covenants	10¾-11½	(10¼-10½)	Good supply for owner occupied premises.
13. Hotels & Motels - Major Leases or covenants	12 PLUS	(11 PLUS)	Terms & conditions are on an individual case basis.
Supplementary Financing			
14. Residential Second mortgages	13-14	(13)	Ample funds.
15. Interim Financing	13-14	(14-15)	Adequate funds.
Other Related Rates			
16. Average Yield - Canada Bonds	8.61	(7.81)	Bond Yields rapidly rising.
17. Consumer Price Index	160.80	(159.20)	Rates are as of March 1974 & February 1974. The CPI has risen 14.5% over the same period last year.

Source: A.E. LePage Limited, Toronto, Ontario. This bulletin is the result of a monthly sampling of the concensus of mortgage lenders in the Toronto area.

rate of interest "being charged yearly or half yearly not in advance".[8] For example, a mortgage with a stated annual interest rate of nine percent effectly costs the borrower $(1 + 9/2)^2 - 1$ or 9.2025 percent per year if compounding takes place semi-annually.

Suppose a loan agreement is such that the borrower is to be charged nine percent per annum compounded semi-annually but interest payments are to be made monthly. The formula for the monthly interest charge (m), equivalent to an annual rate of 9.2025 percent is $(1 + m)^{12} - 1 = .092025$ or $m = .007363$. This value for m is called the "monthly interest factor" and can be found in most mortgage tables.

Finally, suppose a mortgagor borrows \$20,000 at a rate of nine percent compounded semi-annually and wants to amortize the loan over a 20 year period. From a set of mortgage yield tables, the monthly payment is \$177.84 for 240 months. The effective annual cost to the borrower is 9.2025 percent. The first payment consists partly of repayment of principal and partly of the interest payment as follows:

interest (20,000) (.007363)	=	147.26
principal	=	30.58
total monthly payment	=	177.84

For each subsequent payment the amount of interest declines and the amount of principal repayment increases as the debt is gradually repaid.

The NHA Rate

The *NHA rate* is the interest rate paid when a CMHC insured mortgage loan is made by an approved lender. Under the National Housing Act of 1954 the *statutory maximum rate* that could be charged for an NHA loan was 225 basis points above the hypothetical 20 year Government of Canada bond rate. From 1954 to 1966, the *operating maximum rate* was periodically revised by Order in Council in response to changing capital market conditions and had to be within the statutory maximum. Table 3-3 contains the operating maximum NHA rate and the yield on industrial bonds over the period 1954-1969.

Beginning in 1966, quarterly maximums were set at 150 basis points above the long-term (not less than 10 years) Government of Canada bond rate. In October 1967, the NHA operating maximum rate was pegged at 225 basis points above the long-term Government of Canada rate.

During the 1966-1968 period, interest rates rose steadily and the quarterly adjustments in the NHA rate were not frequent enough to keep the rate competitive. These adjustments had a tendency to produce cyclical fluctuations in the flow of funds into mortgages as the rate changed from a competitive one to a non-competitive one and back again. However, more frequent adjustment of the rate was not considered administratively feasible.

8. *Interest Act,* R.S.C. 1970, c. 156, s. 6.

Operating Maximum NHA Mortgage Lending Rate Compared With The McLeod, Young, Weir Industrial Bond Yield Average, Selected Months, 1954-1969 — Table 3-3

Date of Change in Operating Maximum NHA Rate		New Operating Maximum NHA Rate	McLeod, Young, Weir* Industrial Bond Yield Average
March	1954	5.50	4.16
February	1955	5.25	3.97
March	1956	5.50	4.21
January	1957	6.00	5.21
December	1959	6.75	6.14
November	1961	6.50	5.32
June	1963	6.25	5.26
January	1966	6.75	6.03
November	1966	7.25	6.90
April	1967	7.00	6.70
July	1967	7.25	7.08
October	1967	8.25	7.56
January	1968	8.43	7.58
April	1968	9.13	7.91
July	1968	8.88	7.98
October	1968	8.75	7.97
January	1969	9.33	8.24

* These are month-end average rates for 10 industrial bonds which have an average term remaining of about 17 years.

Source: CMHC, *Canadian Housing Statistics,* and McLeod, Young, Weir & Co., Ltd.

The general policy of having an NHA rate ceiling was frequently criticized as it was thought to place an unfair share of the burden of tight monetary policy on the residential construction sector and, particularly, on the middle income home-owners assisted by NHA mortgages.[9]

In June 1969, the NHA was amended to remove the statutory maximum. Operating maximum rates were also discontinued except for CMHC direct lending. When the ceiling was removed, the NHA rate rose but only in proportion to other rates. Since that time, the rate on NHA insured loans has varied between 150 and 300 basis points over the long-term Canada bond rate.

Single Family and Rental NHA Rates

There are now two interest rate series which may be referred to as the NHA insured rate: the rate charged by approved lenders on NHA insured single family

9. See L.B. Smith, "On the Economic Implications of the Yield Ceiling on Government Insured Mortgages," *Canadian Journal of Political Science,* Toronto, August 1967, pp. 420-431.

NHA Interest Rate on Single Family And Rental Properties, 1969-1974

Table 3-4

	1969		1970		1971		1972		1973		1974	
	Single Family	Rental	Single Family	Rental	Single Family	Rental	Single Family	Rental	Single Family	Rental	Single Family	Rental
January	8.84	9.05	10.06	9.96	9.65	10.25	8.83	9.14	9.06	9.13	9.90	9.65
February	9.01	9.19	10.27	9.91	9.47	9.91	8.76	9.36	9.00	9.06	10.09	9.77
March	9.07	9.10	10.21	10.15	8.98	9.64	8.79	8.91	9.02	8.87	10.05	9.59
April	9.06	8.92	10.29	10.21	8.84	9.33	8.78	8.85	9.01	8.88	9.97	9.60
May	9.12	9.27	10.28	10.15	8.97	9.05	8.83	8.89	9.07	9.00	10.56	9.95
June	9.18	9.24	10.24	10.15	8.80	9.18	8.98	8.93	9.25	9.02	10.69	9.82
July	9.39	9.31	10.03	10.32	8.88	9.26	9.02	9.11	9.42	9.08	11.23	10.79
August	9.59	9.60	9.94	10.34	8.99	9.35	9.08	9.08	9.59	9.20	11.29	10.28
September	9.78	9.77	9.97	10.37	9.05	9.23	9.06	9.15	9.72	9.31	11.77	10.78
October	9.87	9.59	9.86	10.27	9.09	9.38	9.14	9.26	9.98	9.27	11.64	10.53
November	9.92	9.70	9.83	10.16	9.05	9.45	9.08	9.22	9.80	9.48	11.80	10.75
December	9.97	9.82	9.79	10.39	8.91	9.13	9.00	9.08	9.88	9.78	11.75	11.27

Source: CMHC, *Canadian Housing Statistics*, 1974.

owner occupied dwellings, and the rate charged on NHA insured rental properties. These two interest rate series are shown in Table 3-4.[10]

The interest rate on single family mortgages exceeded that on rental mortgages for the last half of 1969, the first half of 1970 and most of 1973 and 1974. For almost all other periods the rental rate exceeded the single family rate. One might expect these rates to be the same since both types of mortgages are government guaranteed. There are, however, a number of reasons for the differences between the NHA rental and home ownership mortgage rates. These include the difference in service charges, the use of rental sharing arrangements and institutional preferences.

If one deducts the normal service charge of three-eighths of one percent from the single family yields and one-tenth of one percent from rental yields, the net yield on rental property mortgages is higher than the net yield on single family property mortgages for all periods except 1974. Rental mortgages typically have a higher yield, since a single large mortgage is perceived to be riskier than a number of smaller mortgages. In addition, a package of several single family NHA mortgages is easier to sell to non-approved lender accounts thus commanding a small liquidity premium. The 1974 data which indicates rental yields as much as three-quarters of one percent below single family yields, even after adjusting for different servicing charges, is perhaps explained by the fact that the construction of rental housing declined drastically in 1974. As a result there were few sound rental project NHA mortgages available for such institutions as life insurance companies that preferred long-term investments. The result was that the few rental mortgages available traded at a premium by historical standards.

Agreements whereby the lender would participate in rental income were associated for a period of time with a number of rental property mortgages. This was not a feasible alternative with single family properties. Consequently, the net yield on residential rental property mortgages may have been even higher than the interest rate series in Table 3-4 suggests.

In periods of tight money, the differential interest rates on mortgages may be related to the lending policies of the financial institutions and the size and speed of the impact of monetary policies on their borrowing and lending activities.[11] Chartered banks and trust companies seem to prefer mortgages on single family houses because of their five year term and because they attract customers for other services. In contrast, pension funds and life insurance companies tend to

10. Each month the rates contained in all Undertakings to Insure issued by CMHC for NHA loans are accumulated and weighted by loan amount to create these series. There are several limitations to these data. First, the series is inconsistent since prior to September 1971 the weighting was by number of housing units rather than dollar amount. Second, the rate may not be current since the rates are taken from Undertakings to Insure and actual payout of the funds could begin 90 days or more in the future. There is a possible time lag of up to three weeks between the time when the decision to lend was made and approval by CMHC was granted. It is also possible that if a large loan was granted at an unusual rate in an otherwise quite inactive month, the series could contain an observation which was difficult to explain unless one had access to the raw data.

11. For a discussion of the relative impact of monetary policy on financial institutions see L.B. Smith and G.R. Sparks, "The Interest Sensitivity of Canadian Mortgage Flows," *Canadian Journal of Economics*, August, 1970.

prefer the longer-term mortgages because of the ease of servicing and the fact that they can lock in a return for a longer period of time. Consequently, if tight money has a more immediate effect on banks, rates on single family mortgages would rise relative to rental properties as banks curtail their lending activities.

CMHC Direct Lending Rates

As outlined in Chapter 10, CMHC occasionally enters the housing market, loaning funds to builders and potential home owners on a non-subsidized basis in order to spur residential construction. In these cases, CMHC acts as a lender of last resort after the borrower has been turned down by a number of other approved lenders. These direct lending activities of CMHC come under the umbrella of Sections 58 and 59 of the National Housing Act, and thus, are sometimes referred to as *Section 58 loans.*

CMHC receives a budget allocation from Parliament instead of raising funds in the capital market. The Corporation's direct lending rate is based on the borrowing costs of the Federal government and anticipated administrative expenses but there is no rigid formula. Until 1969, the CMHC direct lending rate equalled the operating maximum NHA rate. Since that time, the direct lending rate, as indicated in Table 3-5, has been below the average for residential NHA insured mortgages.

CMHC Lending Rates and Selected Market Rates
For Selected Dates, 1969-1974 — **Table 3-5**

Date of Change in CMHC Lending Rate		CMHC LOANS: Section 58 Direct Loans	CMHC LOANS: Low Rental & Land Assembly Loans	OTHER MARKET RATES: The NHA Insured Single Family Rate	OTHER MARKET RATES: Government of Canada 5 - 10 year Bond Yield
August	1969	9.50	7.88	9.59	7.79
January	1971	9.25	7.50	9.64	6.04
March	1971	8.75	7.25	8.99	5.83
June	1971	8.75	7.75	8.81	6.45
September	1971	8.75	7.50	9.04	6.17
January	1972	8.75	7.00	8.83	5.99
March	1972	8.75	7.63	8.79	6.79
July	1972	8.75	7.88	9.02	7.09
July	1973	9.50	8.00	9.42	7.50
August	1974	11.25	8.00*	11.29	9.26

* In 1974 a distinction was made between low-rental housing loans (Section 15), where the rate remained at eight percent and other loans such as federal-provincial public housing and land assembly loans (Section 40), where the rate was raised in three increments to 10.375 percent in October, 1974.

Source: CMHC and *Bank of Canada Review.*

In addition to its Section 58 loans, CMHC makes loans for such purposes as land assembly, low rental housing, student housing and sewage treatment projects. The interest rate which CMHC charges for these purposes is also set out in Table 3-5. While these rates have generally followed the upward trend of interest rates, they remain substantially below both the NHA rate and the CMHC direct lending rate. CMHC has a number of other programs, such as the Assisted Home Ownership Program, which not only supplies loans at below market rates but also provides for grants to assist with monthly payments for qualifying persons. These programs are discussed in greater detail in Chapter 10.

Ontario Housing Corporation

The Ontario Housing Corporation, a crown corporation created to administer the housing programs of the provincial government, has historically followed the lead of CMHC in setting interest rates for its HOME Plan direct loans. In August 1973, OHC initially refused to follow the CMHC increase in direct lending rates from 8-3/4 percent to 9-1/2 percent, but eventually raised their own rates as well.

Conventional Residential Mortgage Rates

As a rule, a conventional mortgage is one which is not insured under the NHA. Table 3-6 shows the conventional rate for the period 1951-1974. These data are the result of a monthly survey conducted by CMHC.[12] Table 3-6 shows that the conventional rate rose throughout the two decades after 1950, reaching a level in excess of 10 percent in late 1969 and in 1970. Rates declined somewhat in 1971 and 1972 and continued their upward trend, reaching 12 percent in 1974.

Comparison of Conventional and NHA Rates

The yield on conventional mortgages has historically exceeded the yield on NHA insured mortgages. Until 1968, the yield spread was from one-half to one percent. Then, begining in 1968, the spread began to narrow until in 1973 it all but disappeared. However, in 1974 the spread opened up again. Some financial institutions quote two rates, one for conventional mortgages and one for NHA mortgages. Many financial institutions, however, have only one mortgage lending rate which is adjusted in accordance with other risk factors which are not particularly related to whether the loan is NHA insured.

The spread between conventional and NHA insured interest rates usually depends on the availability of funds. As funds become more plentiful, all rates collapse around the prime mortgage lending rate. When money becomes tight, the spread

12. Initially, this series was the average *prime* rate in five CMHC regions weighted by the number of lenders. It was then changed to a weighted average of the midpoints of the ranges of rates at which loans were actually being made. Finally, because the rate in the Toronto region was so close to the national average, CMHC began to use the weighted average actual rate in the Toronto region as the quoted rate.

Conventional Mortgage Lending Rate, 1951-1974*
(percent)

Table 3-6

Year	Jan.	Feb.	Mar.	Apr.	May	June	July	Aug.	Sept.	Oct.	Nov.	Dec.
1951	5.00	5.00	5.00	5.25	5.50	5.50	5.62	5.62	5.75	5.75	5.75	5.75
1952	5.70	5.70	5.70	5.70	5.80	5.80	5.85	5.85	5.75	5.80	5.80	5.80
1953	5.90	5.90	5.90	5.90	5.90	5.95	5.95	5.95	6.05	6.05	6.10	6.10
1954	6.05	6.05	6.05	6.00	6.00	6.00	6.00	6.00	6.00	6.00	6.00	6.00
1955	6.00	6.00	6.00	6.00	5.75	5.75	5.75	5.70	5.80	5.90	5.95	5.95
1956	5.95	5.95	6.00	6.00	6.00	6.05	6.15	6.35	6.40	6.55	6.65	6.65
1957	6.70	6.75	6.75	6.75	6.75	6.85	6.85	6.90	7.00	7.00	7.00	6.95
1958	6.95	6.90	6.80	6.75	6.75	6.75	6.75	6.75	6.75	6.80	6.80	6.80
1959	6.85	6.85	6.85	6.80	6.80	6.85	6.85	6.95	7.20	7.20	7.25	7.25
1960	7.30	7.30	7.30	7.30	7.25	7.25	7.15	7.15	7.10	7.00	7.00	7.00
1961	7.00	7.00	7.00	7.00	7.00	7.00	7.00	7.00	7.00	7.00	7.00	7.00
1962	7.00	7.00	7.00	6.90	6.80	6.95	7.00	7.00	7.00	7.00	7.00	7.00
1963	7.00	7.00	7.00	6.94	6.91	6.91	6.91	7.00	7.00	7.00	7.00	7.00
1964	7.00	7.00	7.00	6.95	6.88	6.88	6.88	7.00	7.00	7.00	7.00	7.00
1965	6.90	6.85	6.82	6.82	6.83	6.83	7.02	7.13	7.15	7.25	7.29	7.40
1966	7.38	7.45	7.46	7.48	7.51	7.57	7.68	7.80	7.84	7.87	7.91	7.95
1967	7.93	7.89	7.83	7.80	7.77	7.88	8.02	8.05	8.10	8.49	8.52	8.52
1968	8.83	8.84	8.96	9.20	9.23	9.18	9.14	9.12	9.03	9.01	9.09	9.10
1969	9.45	9.45	9.48	9.52	9.46	9.69	9.90	9.99	10.11	10.21	10.30	10.50
1970	10.58	10.54	10.58	10.60	10.58	10.53	10.38	10.40	10.36	10.35	10.28	10.16
1971	9.94	9.72	9.28	9.20	9.25	9.34	9.46	9.53	9.55	9.55	9.26	9.10
1972	9.04	8.93	8.97	9.03	9.16	9.37	9.41	9.41	9.38	9.35	9.30	9.22
1973	9.09	9.02	9.07	9.15	9.30	9.52	9.71	9.91	10.13	10.13	10.08	10.02
1974	10.02	10.01	10.04	10.70	11.26	11.37	11.60	11.85	12.05	12.05	12.00	11.88

*The conventional mortgage rate shown here is a simple average of rates charged by institutional lenders for non-NHA residential mortgage loans.

Source: CMHC, *Canadian Housing Statistics.*

between conventional interest rates and the NHA interest rate opens up. For example, in mid-1974, a period during which general demand for funds was still quite high, the quoted NHA rate was from one-quarter to one-half of one percent below the conventional rate for single family houses.

Conventional Mortgages and Corporate Bonds

Over the last decade, the interest rate on conventional mortgages has remained higher than that of corporate bonds. Until 1966, this spread was at least 125 basis points and often higher; beginning in 1966, the spread fluctuated between 75 and 175 basis points. Table 3-7 compares conventional mortgage and bond yields over the 1969-1973 period.[13]

Why is there a spread between the conventional rate and the corporate bond rate? Some of the reasons include servicing costs, risk differences, marketability, maturity features and institutional preferences.[14] Between one-tenth and three-eighths of one percent of the difference between bonds and conventional mortgages is explained by the cost of servicing mortgages.

A second reason for the spread may be the existence of a premium for risk. Although mortgages have a very low default rate and can be privately insured, a large mortgage on a single property is considered a higher risk than, for example, a high quality corporate bond.

The degree to which mortgages are marketable is discussed later in this chapter. However, there is a feeling by some investors that mortgages are much less liquid than bonds and therefore must command a higher yield in the market. Not only is there a shortage of quotes to buy and sell large blocks of mortgages but they are considered less convenient to sell as well, due to the perceived need for more careful evaluation of each mortgage.

Another factor favoring bonds is the feeling among a number of institutions that they can increase the yield on their bond portfolio by shrewd trading, an option not available with mortgages which are considered to be a buy and hold investment. A final advantage in favour of corporate bonds is the fact that there is usually no risk of prepayment unless a call privilege has been written into the bond agreement. Mortgages, however, frequently have a clause which permits the borrower to prepay the mortgage and as discussed earlier, the Interest Act and NHA allow an individual to prepay a mortgage under certain circumstances.

13. One must be cautious in comparing these two series. The conventional mortgages are primarily five year term while the bonds are over 10 year term. Thus, some of the spread between these two classes of security may be due to the changing term structure of interest rates over the period.

14. One writer foresees a number of factors which will cause a narrowing of this spread in the future to about one-half of one percent. See C. Frank Chasney, "Mortgage Rates and the Market," *Bond and Money Markets,* Toronto: Fry, Mills, Spence Limited, April 4, 1973.

Interest Rate on Conventional Mortgages and Corporate Bonds, Monthly, 1969-1974

Table 3-7

	1969		1970		1971		1972		1973		1974	
	Conventional Mortgage	Corporate Bonds*	Conventional Mortgage	Corporate Bonds*	Conventional Mortgage	Corporate Bonds*	Conventional Mortgage	Corporate Bonds*	Conventional Mortgage	Corporate Bonds*	Conventional Mortgage	Corporate Bonds*
January	9.45	8.18	10.58	9.36	9.94	8.16	9.04	8.26	9.09	8.18	10.02	9.00
February	9.45	8.22	10.54	9.33	9.72	8.33	8.93	8.22	9.02	8.19	10.01	9.01
March	9.48	8.34	10.58	9.28	9.28	8.39	8.97	8.25	9.07	8.24	10.04	9.25
April	9.52	8.31	10.60	9.27	9.20	8.49	9.03	8.30	9.15	8.31	10.70	9.97
May	9.50	8.51	10 58	9.34	9.25	8.53	9.16	8.33	9.28	8.46	11.26	10.16
June	9.69	8.79	10.53	9.30	9.34	8.64	9.37	8.39	9.52	8.45	11.37	10.47
July	9.90	8.87	10.38	9.18	9.46	8.68	9.41	8.38	9.71	8.56	11.60	10.83
August	9.99	8.88	10.40	9.23	9.53	8.52	9.41	8.44	9.91	8.73	11.85	11.05
September	10.11	8.87	10.36	9.21	9.55	8.41	9.38	8.51	10.13	8.63	12.05	11.00
October	10.21	8.90	10.35	9.25	9.55	8.27	9.35	8.45	10.13	8.65	12.05	10.46
November	10.30	9.06	10.28	9.09	9.26	8.19	9.30	8.25	10.08	8.74	12.00	10.34
December	10.50	9.32	10.16	8.87	9.10	8.30	9.22	8.17	10.02	8.85	11.88	10.76

* McLeod, Young, Weir & Co. Average of 20 corporate bonds. One should really be using a 5 year term bond yield index to be more comparable to mortgages but such an index was not available.

Source: *Bank of Canada Review*, various issues.

A number of institutions have rules of thumb regarding the yield spread that should exist between bonds and mortgages before the latter become attractive investments. Generally, the preferred spread is from one-half to three-quarters of one percent after allowing for servicing charges. As indicated earlier, the spread between mortgages and corporate bonds may be understated to some extent, because conventional mortgages can have participation features associated with them which can provide for a somewhat higher than stated yield.

Large corporate borrowers may prefer to issue mortgages rather than mortgage bonds. Mortgage bonds are fairly expensive to issue, especially in small amounts, because of substantial legal, trustee and registration fees as well as the cost of printing. However, a mortgage bond can be issued for 100 percent of value, whereas, it may only be possible to obtain 75 percent of the value of the asset using a conventional mortgage. Another reason for the use of mortgages is that most trust deeds (the instruments creating mortgage bonds and unsecured debentures) limit further debt financing. There is, however, no restriction on the issuing of mortgages when purchasing new property.

Participation Mortgages[15]

In order to increase yields and hedge against inflation, some lenders attempt to have a participation agreement in respect of property being mortgaged. A variety of participation agreements have been tried. Some of these include:

- "A base interest rate plus participation in gross revenue": For example, a lender takes a share of rental income in a shopping centre based on sales by individual stores. There is usually an allowance for a possible increase in taxes.
- "A base interest rate plus participation in net income": This is sometimes used in apartment projects. The participation is normally stated as a percentage of rental income above a base figure such as 95 percent occupancy in the first year.
- "A purchase lease-back agreement": In this case a part of the project, normally the land, is purchased from the builder and leased back to him. The lender is hedging against inflation by anticipating a long-term increase in land values. This type of arrangement is most appropriate for long-term lenders such as life insurance companies.
- "Purchase of equity in the project": An example of this is to take a part ownership in the development company formed to manage the project.

Participations or "equity kickers", as they are sometimes called, appear to be more popular when money is tight. They were fashionable in 1970 when interest

15. For a good discussion of participation mortgages, see "Notes on the Financing of Real Estate," *Canadian Mortgage Market Review,* Toronto: Morguard Trust Co., June 1973.

rates on mortgages were at an all time high. At that time, some lenders insisted on equity participation to compensate for higher risk or as a condition for allocating funds to some borrowers. It was not unusual for some lenders to accept a slightly below market rate in order to obtain a participation agreement. Since participation mortgages have meant sharing profits but not losses, they are not particularly popular with developers. There is also some indication that properties financed by participation mortgages have been more difficult to sell.[16] From the lender's standpoint, rising costs have sometimes meant that anticipated benefits from income participation have not materialized. Most lenders have only a small portion of their portfolio in participation types of mortgages.

Mortgage Interest Rates and Timing

Mortgage loans on new residential construction are usually allocated in advance of actual payout. A commitment to lend is made and construction begins within 30 to 90 days. Single family house construction can take place within a relatively short period of time, while a major undertaking, such as an apartment complex, could take from 12 to 24 months. A common rule of thumb in this regard is one storey per month. Funds are advanced as construction progresses, but the timing of the advances may vary from the original plan due to construction delays. Rather than be involved in a series of uncertain advances, some lenders prefer to look for a project which has been completed using interim financing and to provide long-term mortgage money on a takeout basis. This only removes some of the timing uncertainty as the takeout commitment is usually made far in advance of the need for long-term funds. A more desirable option, from the standpoint of timing, is to look for lending situations where no precommitment is necessary and the funds can be placed immediately. Except for refinancing situations, these opportunities are scarce. When there are excess funds in the mortgage market, the yield to the lender on immediate payout mortgages may be from one-eighth to one-quarter of one percent below the rate on gradual payout mortgages.[17] When a mortgage rate is quoted it normally refers to drawdown or precommitted takeout mortgages.

A developing trend, particularly with respect to condominium projects, is the use of floating rate loans. Under this arrangement the advances to the builder are made at a rate which floats with the general level of interest rates such as 150 basis points above the rate on five year guaranteed investment certificates. The rate may change frequently during the course of construction on a large project. The builder is usually given the right to fix the mortgage rate at the floating rate in effect at the date of sale.

16. For a technical discussion of the problems that a developer faces with leasebacks, see E. Mirth, "A Look at Leasebacks," *Canadian Mortgage Market Review*, Toronto: Morguard Trust Co., October 1974.

17. See *Canadian Mortgage Market Review*, Toronto: Morguard Trust Co., January 1973.

Some institutions have indicated that there is a slightly higher premium for a mortgage which has been "seasoned" for a period of one or two years. The existence and amount of this premium are difficult to determine.

Regional Mortgage Interest Rates

Researchers and government agencies have long been interested in whether there are mortgage interest rate differentials between various regions. The contention is sometimes made that financial institutions service their local market demand first and only then provide mortgage funds, at a higher cost, to outlying areas. This may be less true today, as the entry of banks into the market, the national expansion of trust companies and the growth of local credit unions all tend to minimize regional differentials. Little study has been done on this subject in Canada and the work that has been done in the United States has produced conflicting results.[18] It is interesting to note that the United States Senate Banking Committee recently approved a bill requiring mortgage lenders to disclose the location of their mortgage loans by neighbourhood.

CMHC collects information on the average rate on NHA insured loans made by approved lenders in five Canadian regions.[19] These data suggest that rates in the Atlantic region and British Columbia are frequently above the national average while rates in Quebec are frequently below the national average.

The Ontario Ministry of Treasury, Economics and Intergovernmental Affairs conducts an annual survey of mortgage loans registered in Ontario.[20] For 1973, these data indicated a substantial regional difference in interest rates, with the Lake Erie region having consistently lower rates and the Northeastern Ontario region having consistently higher rates. Due to the crude nature of the data, the reader should consider these comments as suggestive rather than as firm conclusions. The survey makes no distinction between first and second mortgages, commercial and industrial mortgages, or by the type of institution originating the mortgage.

Although there is a lack of adequate published data on regional interest rates, discussions with lenders suggest that there may be an interest rate differential between various regions of Ontario by as much as three-quarters of one percent. Rates may be higher in those rural areas and towns where there is only one industry, partly because there is less competition between lenders in more isolated areas and partly because the property being mortgaged is less saleable making the exposure in the event of default higher. In times of severe credit rationing, there is a tendency on the part of smaller financial institutions to concentrate

18. See G.M. von Furstenberg, "Interstate Differences in Mortgage Lending Risks: An Analysis of the Causes," *Journal of Financial and Quantitative Analysis,* June 1970.

19. See CMHC, *Canadian Housing Statistics,* Ottawa, 1974.

20. See Ontario, Ministry of Treasury, Economics and Intergovernmental Affairs, *Realty Mortgage Loans Registered in Ontario During 1973,* Toronto: Queen's Printer, 1973.

their lending in the local market area. However, this tendency is less pronounced with major national financial institutions.

The regional allocation of funds is also of concern to borrowers. It is of no benefit to the borrower when a financial institution advertises their national rate but fails to make any funds available at any rate. In 1969, the Federal Task Force on Housing indicated that there were regions in Canada where there appeared to be inadequate mortgage financing by institutions.[21]

Other Factors Influencing Mortgage Yield

One might expect that mortgage lenders would establish a prime rate which could be increased to compensate for any increase in the perceived risk of a loan. In fact, individual national mortgage lenders have quite a narrow range of rates. For example, in May 1974, Kinross Mortgage Corporation quoted an NHA rate of 11.50 percent, a prime conventional rate of 11.75 percent and a rate of 12 percent for all other mortgage loans.[22] The smaller trust companies are able to compete with the larger national firms partly because of their willingness to accept higher risks for which they charge higher rates.

Instead of increasing rates it is more common for lenders to keep the rate relatively inflexible and lower the risk. One way of decreasing risk is to cut the loan to value ratio or the maximum amount that will be loaned on any one property.[23] Other devices include more restrictive amortization periods, and restrictions on type of property and borrower characteristics.

When there is a new type of project entering the market, higher interest rates are more common. For example, condominiums and nursing homes were once considered new types of projects and as a result their interest rates were higher than the market rate.

DEFAULT RISK

The mortgage lender is exposed to a number of risks including illiquidity, late payment of principal and interest, and loss of principal. This section considers the risk of late payment and foreclosure while the next section deals with illiquidity risk.

21. See *Report of the Federal Task Force on Housing and Urban Development*, Ottawa: Information Canada, 1969, especially p. 26.

22. "Kinross Raises Prime to 11.75% for Mortgages," *The Globe and Mail*, Toronto, May 25, 1974.

23. For examples of firms employing this strategy, see "Lenders Limiting House Mortgages, Fear Price Drop," *The Globe and Mail*, Toronto, May 21, 1974.

Default Rates

A mortgage loan is backed by the financial resources of the borrower and the underlying value of the property mortgaged. In addition, many mortgage loans are insured by CMHC or private insurance companies.

As seen in Table 3-8, the loss and arrears experience of CMHC has been quite favorable. In 1974, claims paid out by CMHC for insured mortgages totalled $19.8 million compared to $40 million in 1973, $29 million in 1972 and $7 million in 1971. The increase in claims from 1971 to 1973 was attributable primarily to a number of multiple housing project acquisitions.

Insurance or Guarantee in Force, Profit or Loss On Operation and Disposal of Real Estate, and Default Rate on NHA Mortgages Administered by CMHC and Approved Lenders, 1954-1974 **Table 3-8**

PERIOD	MORTGAGE INSURANCE FUND: Insurance or Guarantee in Force* ($ thousands)	MORTGAGE INSURANCE FUND: Profit / (Loss) on Operation and Disposal of Real Estate ($ thousands)	Loans in Arrears 3 Months or More per Thousand Accounts under Administration: CMHC	Loans in Arrears 3 Months or More per Thousand Accounts under Administration: APPROVED LENDERS
1954	124	—	—	—
1955	529	—	—	—
1956	1,083	—	—	—
1957	1,425	4	—	—
1958	2,100	8	—	—
1959	2,733	6	—	—
1960	3,090	14	—	—
1961	3,640	(66)	—	—
1962	4,123	42	—	—
1963	4,499	(25)	5.3	4.1
1964	4,934	(201)	5.6	4.1
1965	5,321	(890)	4.7	3.5
1966	5,789	144	3.1	2.5
1967	6,311	578	1.8	1.8
1968	6,732	134	1.6	1.5
1969	7,412	170	1.5	1.6
1970	8,051	104	2.1	1.9
1971	9,225	(94)	2.9	2.5
1972	10,056	(1,098)	4.5	3.4
1973	11,089	(3,504)	4.5	2.9
1974	11,915	(5,032)	3.9	2.4

* As at December 31.

Source: CMHC, *Annual Report*, various issues.

The Mortgage Insurance Company of Canada (MICC), Canada's largest private mortgage insurance company, reported a three months arrears ratio of 0.39 percent in 1974 compared to ratios of 0.29 percent in 1973 and 0.23 percent in 1972. Table 3-9 below shows the losses on claims that have been made to MICC

in the last four years. Due to the rapid growth in business, these statistics may underestimate the losses to be expected in the future as the new loans make themselves felt in the default and claims statistics. In addition, the 95 percent loan to value ratio was first introduced in late 1972 and a somewhat higher loss ratio may be expected from this business.

Insurance in Force and Losses on Claims by the Mortgage Insurance Company of Canada, 1971-1974 — **Table 3-9**

	Insurance in Force	Losses on Claims*
1971	$ 460 million	$ 42,500
1972	965 million	98,000
1973	2,200 million	258,000
1974	3,600 million	849,000

* Includes losses on reinsurance of 95 percent mortgage loans in the United States amounting to $1,000 in 1971, $40,000 in 1972, $237,000 in 1973, and $590,000 in 1974. New reinsurance business was substantially reduced after June 1973.

Source: MICC, *Annual Reports,* 1972 and 1973.

There are no public statistics on conventional mortgage defaults but discussion with individuals at financial institutions indicated low default and loss rates. One bank, for example, reported that less than one percent of all mortgages were in arrears and foreclosures were almost negligible. Another bank reported a delinquency rate of about 2 1/2 percent with less than one-half of one percent of mortgages over three months in arrears. Finally, a trust company indicated that less than one percent of its loans were over 30 days in arrears and that there were very few foreclosures.

The above indicates that, at least in the last few years, the default and loss rates on mortgages were low and that mortgages should be considered a relatively low risk investment under current economic conditions. Of course, to obtain a proper perspective of the risk associated with mortgages, one should look at historical default rates, particularly in times of economic stringency.

There are several reasons why the default rate is presently so low. One could point to a generally conservative bias on the part of the approved lenders under both the private insurance plans and the NHA insurance plan. When a substantial amount of risk exists, these financial institutions either do not make the loans or else use devices such as decreasing loan to value ratios in order to decrease exposure. In addition, builders and developers are becoming larger and better able to avoid some of the pitfalls associated with the construction and operation of buildings. It is standard practice for lenders to hold back sufficient funds from mortgage advances to complete the project should the builder or developer expe-

rience financial difficulties. One factor that presently seems to dominate all others is the onset of a high rate of housing price inflation. An individual borrower who finds it difficult to make his payments, can usually sell the house at a reasonable price and pay off the mortgage or have the purchaser asume the mortgage. This makes the loss statistics look considerably better. Lenders have been concerned with this phenomenon, particularly in the Toronto market. A 95 percent high ratio mortgage provides very little protection in a falling price market. A number of lenders thought that the house prices in Toronto may have been excessive by approximately 10 percent due to a scarcity premium. If a larger supply of housing should suddenly become available, the prices of some of the existing houses could conceivably fall or at least stop their rapid rate of increase. A final reason for low default rates is that the economy did not experience a serious recession during the period under consideration. The economic slowdown of late 1974 and 1975 may cause defaults to rise somewhat.

Factors Related to Default

A major study of home mortgage delinquency and foreclosure was done by Herzog and Earley in the United States, covering the period 1950 to 1963.[24] For the year 1963, they employed a multiple regression technique in an attempt to uncover the major loan and borrower characteristics that were related to default.

Factors shown to be positively related to delinquency were:

- borrowing for refinancing;
- presence of junior financing;
- loan to value ratio; and
- number of dependents.

In addition, the occupation of the borrower and geographical region helped to explain delinquency. All of those factors which led to delinquency were also closely related to claims.

Discussions with lenders indicated that losses on claims occur more frequently in the early stages of a mortgage loan when there is a minimum amount of equity; the first two years appear to be the most critical. Over time, the borrower's income typically rises while his payments remain fixed. When a mortgage is transferred from one borrower to another, the new borrower is not screened by the financial institution. One financial institution indicated that a majority of their default problems were caused by these second borrower situations.

24. J.P. Herzog and J.S. Earley, *Home Mortgage Delinquency and Foreclosure,* New York: National Bureau of Economic Research, 1970. For a study with more recent data supporting the Herzog and Earley results, see G. H. von Furstenberg, "Home Mortgage Delinquencies: A Cohort Analysis," *The Journal of Finance,* December 1974.

LIQUIDITY

The Illiquidity of Mortgages

At the present time, mortgages must be considered as a relatively illiquid investment in the sense that it would be difficult to sell a block of mortgages without a substantial sacrifice of price. Moreover, it would be particularly difficult to sell a very large block of mortgages in times of tight money, without dragging the sale out over an extended period of time.[25]

There are many possible causes of this illiquidity. It requires a lot of time to package and appraise a block of mortgages. Buyers tend to shop around, putting much more effort into the purchase of mortgages than they would into the purchase of bonds. Many firms do not even consider mortgages as potential investments. There appears to be a general belief in the mortgage market that mortgages are illiquid, and the wide prevalence of this belief, regardless of the facts of the case, may make mortgages even less liquid.

When one looks at the various institutions that participate in the mortgage market, one comes to the conclusion that there is not a great deal of need for liquidity from mortgages. Pension funds have large periodic cash inflows; insurance companies have regular premium payments; and chartered banks use other devices such as investment accounts in order to manage their liquidity. Trust and loan companies, which have a very high proportion of mortgages in their portfolio, should perhaps be the most concerned with the liquidity of mortgages. However, discussions with these institutions revealed that they did not view mortgage liquidity as a major problem. Those trust companies that were experiencing difficulties in recent years were generally facing insolvency rather than illiquidity. This insolvency was largely caused by problems associated with rising interest rates. Generally speaking, mortgages are looked upon as long-term buy-and-hold investments rather than as securities for trading purposes.

The Liquidity of Mortgages

NHA insured mortgages are generally the most marketable mortgages available. This is because there are a greater number of buyers interested in the government guarantee associated with NHA insured mortgages. In general, these mortgages tend to be more standardized and have more uniformity of risk. Investors also prefer the CMHC insurance plan because they never have to take possession of the property if a default occurs.

Mortgages can also be thought of as containing a substantial amount of built-in liquidity due to regular interest and principal payments. A relatively new or rapidly growing mortgage investor would not have as much liquidity, as the

25. The concept and measurability of liquidity is controversial under the best of conditions, but is particularly complex with respect to mortgages due to the lack of readily available data. This would be an interesting research topic.

largest proportion of his portfolio would be tied up in relatively new mortgages that were not presently repaying a large amount of the principal.

Several financial institutions have introduced methods which provide a type of liquidity for investors. One method is the ***buy-back agreement***, wherein the financial institution sells a mortgage to a customer and promises to buy it back in the future at a discount from the prevailing rate. This buy-back agreement is used in all of the mortgage sales of at least one trust company. One chartered bank recently deleted the buy-back agreement for all but the smallest individual investors. Some institutions do not encourage buy-back agreements because they are trying to foster a true secondary market for mortgages and do not want the purchaser to have a "crutch" to rely on. They do not find the lack of a buy-back agreement any inhibition to the sale of the mortgages. Trust companies that have captive pooled mortgage funds usually guarantee that they will buy back any mortgages that the fund wishes to sell. An example of this type of agreement is the one between the Royal Trust Company and its M-Fund. Chartered banks have similar arrangements with their affiliates. The bank may have an affiliate which stands ready to purchase mortgages from the bank's portfolio should the bank run into liquidity problems. In order to finance such purchases the bank affiliate will issue short-term paper or guaranteed investment certificates in the open market. An example of this relationship is the one between the Toronto Dominion Bank and Tordom Mortgage Corporation. Trust companies often have arrangements with their estate, trust and agency accounts wherein the trust company agrees to buy back any mortgages that these accounts wish to sell.

It is commonly believed by people in the industry and in government that if a federal mortgage exchange ever comes into being, it will substantially increase the liquidity of mortgages. A discussion of the potential for this type of arrangement along with other aspects of the purchase and sale of mortgages is included in Chapter 17.

VARIABLE TERMS MORTGAGES

Thus far we have considered various existing investment features of mortgages. It is conceivable that within the next few years mortgages may be made much more flexible than at present through the use of variable terms. Although variable terms mortgages are not currently used in Canada, they are being successfully used in Britain and some parts of the United States. The following discussion is intended to give a brief overview of some of the advantages and difficulties associated with this proposed new instrument.[26]

The Nature and Advantages of Variable Terms Mortgages

A *variable terms mortgage* (VTM) is "a mortgage wherein provision is made for the variation of specified terms of the loan, especially the interest rate and the

26. For a brief but readable discussion of this topic, see "Variable Rate Mortgages: Boon or Bane," *Business Review*, Federal Reserve Bank of Philadelphia, September 1972.

amortization period, on a predetermined basis during the lifetime of the contract."[27]

VTM's are desirable for lending institutions as they allow the institution to protect itself against swings in interest rates. If interest rates are rising, an institution, such as a bank or trust company that borrows in the short-term market and lends in the mortgage market, will find the margin between borrowing and lending rates narrowing as short-term rates rise. If the interest rate on a VTM were allowed to fluctuate with the general level of interest rates, the lender could maintain a profitable spread between borrowing and lending rates. In theory, this would encourage short-term borrowers to invest funds in mortgages. It should be noted, however, that in periods of falling interest rates investors would, conversely, not have the advantage of having locked-in high yields on mortgages.

If the interest rate paid by the borrower is allowed to fluctuate over time, so would his monthly payments. To avoid this problem, most VTM proposals suggest that monthly payments remain constant and the amortization period be adjusted to reflect changing interest rate levels. The use of VTM increases the uncertainty of the borrower while decreasing the uncertainty of the lender. It is not expected, however, that the borrower would be too concerned as he tends to focus on his monthly payment rather than the amortization period and thus would be quite willing to accept this uncertainty. In addition, by taking on some of this uncertainty, the cost to the borrower may well be lowered. Some authors contend that variable terms mortgages, if used in a flexible way, would make it easier for the borrower to more closely tailor his borrowing and lending activities to his own family life cycle.[28]

Potential Problems in the Use of VTM's

A number of problems must be successfully overcome before VTM's can be implemented. One of these concerns the choice of a reference interest rate. If the interest rate on the mortgage is to vary over time, it must either be managed by the lending institution or must vary in accordance with the change in some interest rate series such as the prime rate or the Canada bond rate. Various lenders, based upon their different asset and liability structure, would normally prefer different reference rates. One Canadian economist has proposed the use of a one year rate[29] while another economist prefers an intermediate term interest rate.[30]

27. J.V. Poapst, ed., *Developing the Residential Mortgage Market*, III, Ottawa: CMHC, 1975, p. 1. This is the most extensive study that this author has seen on the topic of variable terms mortgages and would be valuable reading for anyone conducting research in this area.

28. See *Ibid*, p. 2.

29. See P. Halpern, "Variable Rate Mortgages Analysis and Review," Poapst, ed., *Ibid.*

30. See G. Rich and S. O'Connor, "Choice of an Optimum Anchor Rate," Poapst, ed., *Ibid.*

A second problem has to do with the frequency and amount of interest rate changes. There is a trade-off between a perfectly flexible rate and high administrative costs. In fact, some lenders consider any use of flexible rates as administratively cumbersome. Obviously any extensive use of flexible rates would require reasonably sophisticated administration.

Where the amortization period is allowed to increase as interest rates rise, it is conceivable that the amortization period could exceed the life of the asset being mortgaged. In such a case, the lender may not feel that his investment is being adequately protected. Another problem that could occur is the monthly payment might become inadequate to pay off the interest, thus causing the principal to increase over time. If monthly payments are allowed to vary, the home-owner takes on all of the uncertainty and the scheme becomes undesirable from his standpoint.

In order to successfully carry out a VTM program, both lenders and borrowers would have to become more familiar with the concept. This process could be quite slow since there is evidence that borrowers are not yet very knowledgeable about the mortgage instrument itself. Another technical problem is that a revision of the Interest Act would be required to permit the use of VTM's.

Rapidly rising interest rates in 1974 led many lenders to look into the possibility of VTM's.[31] However, many of the above questions would have to be resolved before such a plan was implemented. The reader who would like to pursue this question in greater depth is encouraged to consult the work by Poapst referred to earlier or a well-written paper by John R. Ferguson.[32] The Poapst study tends to give the impression that variable terms mortgages would be both feasible and helpful to the Canadian economy, whereas the work done by Ferguson tends to suggest that variable terms mortgages are neither needed nor particularly feasible.

31. See "Money Lenders consider Variable Interest Rate Mortgages," *The Globe and Mail*, Toronto, May 24, 1974.

32. J.R. Ferguson, *A Study of Variable Interest Rate Mortgages and an Assessment of their Possible Advantages to the Canadian Mortgage Market*, Ottawa: J.R.F. Consultants Ltd., August 1970.

Chapter 4

Steps in Mortgage Origination

The objective of this chapter is to outline the process by which mortgages are originated. A detailed examination of some of the more complex issues, such as mortgage insurance, mortgage administration, and land development, is deferred until later chapters. Mortgage brokers are frequently involved in the early stages of mortgage origination. They play an important role acting as an agent between lender and builder, doing much of the documentation and sometimes making the presentation to the lender on the builder's behalf. These important market participants are discussed in Chapter 8.

Four variations of the mortgage origination process will be discussed here:

- origination of an NHA mortgage on a new house;
- origination of a privately insured mortgage on an existing house;
- origination of a second mortgage on an existing house; and
- origination of an NHA mortgage on an apartment building.

Three caveats must be applied to the discussion that follows. First, it tends to imply a single series of steps in the mortgage origination process while, in fact, there are often many optional ways of achieving the same objectives. Second, the exhibits provided convey the impression that the various steps are sequential while, in practice, the order of the steps may be different or several steps may take place at once. Third, since interest rates, loan to value ratios, insurance fees and other technical characteristics of mortgage origination are subject to constant change, the examples provided herein should be interpreted as illustrative only.

ORIGINATION OF AN NHA MORTGAGE ON A NEW HOUSE

As discussed in Chapter 1, a new house could have an NHA mortgage or a conventional mortgage. The conventional mortgage could be insured or uninsured. In this section, the origination of an NHA mortgage on a new house is illustrated along with some of the ways in which the process differs from the origination of a high ratio or conventional mortgage. The reader should consult Exhibit 4-1 while reading this section.

Origination of an NHA Mortgage on a New House — **Exhibit 4-1**

The land is purchased	100 acres – Cost $1.2 million. Farmer takes a first mortgage of $1 million at 8% for 5 years. Purchaser pays $200,000 cash.
The land is divided into lots	500 lots at an initial cost of $2,400 per lot.
The lots are improved	Cost of servicing is $5,000 per lot. Selling price at this point $10,000 per lot.
The builder approaches lender for funds to be allocated for the forthcoming year	The builder wants to finance 100 houses. He requests a $3.3 million allocation. A standby fee of ⅜ of 1 percent or $12,375 is paid.
Formal application is made for mortgage loans on the houses to be constructed in the first quarter	Selling price $35,000. A 95% loan to value ratio implies a loan of $33,250 per house. Addition of a 1% insurance fee means that the mortgages are $33,582 per house.
The Plans are evaluated by the lender and a letter of commitment is signed conditional on CMHC approval	
Application for mortgage insurance is made to CMHC and following their analysis an undertaking to insure is issued	
All documents are passed to a lawyer	The lawyer sets up a trust account for the builder to receive the advances as they are made and hold them until all liens are cleared. Builder pays interest from the date of deposit in the account.
Construction starts	
The insulation stage is reached	
CMHC inspects the property and notifies the lender that the first advance may be made	
The lender passes a cheque for the first advance to the lawyer	$9,515 advanced on the first house.
The lawyer completes the title search and when he is sure there are no liens he passes the cheque to the builder	
Second advance at "finished plaster" stage	$9,515 advanced.
Lawyer does subsearch of title for liens before passing on cheque	
Third advance at completion stage by the same route	$9,515 advanced.
15% of funds are held back until 37 days after the house is sold to an approved purchaser	
Potential buyer approaches builder	
Agreement of sale is signed	
Buyers credit worthiness is established by approved lender	
Closing transaction takes place	Adjustments for taxes, insurance etc. are made. Deed is given to buyer and he assumes the mortgage.
Owner takes possession	
Final payment is made to builder	$5,037 is paid to complete take down.

As indicated in the exhibit, the first step in the creation of new housing typically occurs when a developer acquires a tract of land for development. For our purposes, the seller is a farmer and we have assumed that a speculator is not involved. The buyer purchases 100 acres at a cost of $1.2 million or $12,000 per acre. The farmer is paid $200,000 cash down and is willing to hold a $1 million, five year term, with an eight percent first mortgage on the land for the balance. The $200,000 cash down payment paid by the builder for the land may have been from his own working capital but it is more likely that the funds were provided by a bank or other interim lender in the form of a three to five year term loan.[1] The term loan would be at two to three percent above the bank prime rate. When a developer is not a prime borrower, he may have to go to private sources and pay from 14 to 17 percent for the loan. This is a fairly high risk investment as undeveloped land is not easily turned into cash. The term of the mortgage is five years, as it may take from three to five years before the 100 acres of land is fully serviced or until the project is entirely completed and the land is sold.

A payment schedule over a five year term and usually consisting of interest only would probably be set up for the farmer. In order to sell a house and the property on which it stands, the developer must have free and clear title to the property. Thus, the mortgage would provide for the developer to obtain clear title to portions of the land as needed by making a specific payment for each acre acquired. To protect the farmer's interest, the partial repayment of the mortgage is usually higher than the proportionate value of the land being released.

At this point, the developer begins a long process which will hopefully result in an approved subdivision plan and a number of serviced lots. It has been assumed that he has permission to proceed with the subdivision of the property into 500 lots, each of which have cost him $2,400 and will contain a single family house. The subdivision approval process is discussed in detail in Chapter 7.

The lots are converted from raw land to *serviced land* through the installation of facilities such as curbs, gutters, sewers and street lighting. Assuming that services have cost $5,000 per lot, the total cost is now $7,400 and, allowing for profit, the market price of each serviced lot is about $10,000.[2] The cost of installing these services could be financed by a number of financial institutions such as banks and real estate investment trusts. In the past, some of the major utility companies participated in the financing if their services were installed; however, with tightening energy supplies and rising prices, this type of assistance is less common.

The developer's business is quite risky. If he has fully serviced his lots, paid all the costs, and economic downturn occurs, he could go bankrupt because he has fixed payments to make and yet would be unable to sell his lots at a profit. To

1. A discussion of interim financing can be found in Chapter 7.

2. This price could vary widely depending on such factors as location, soil condition, servicing requirements and municipal levies.

avoid this problem, the developer may not service the entire subdivision at once. Instead, he may service some of the lots, sell them, and use the cash flow to service another part of the development. Large developers are often builders as well, enabling them to choose between selling the serviced lots to small builders or building themselves. Developers often sell lots to the smaller builders to speed the completion of the subdivision.

In our case, the builder decides to build 100 homes which will sell for $35,000 each. Assuming a 95 percent mortgage and a one percent insurance fee for each house, the builder must approach a financial institution for a preliminary allocation of mortgage funds amounting to over $3.3 million. In November or December,[3] the lender formally notifies the builder that the funds will be made available at a rate of one-quarter of the allocation every three months. As a sign of good faith, the borrower is required to pay a standby fee (sometimes called a commitment fee) of three-eighths of one percent of the loan amount. The fee is refunded if the builder makes his first draws[4] as scheduled but otherwise is forfeited.

About one month before the beginning of each quarter, the builder approaches the financial institution with an application for 25 mortgage loans. The lender evaluates the builder's plans, inspects the property and signs a *letter of commitment* in which the lender agrees to provide mortgage loans for 25 homes provided a number of stipulations are met. The level and method of determining the interest rate is stipulated at the time the letter of commitment is signed. It is common to set the mortgage interest rate at the time of commitment or when the house is sold. At the beginning of each new quarter, a new letter of commitment is signed.

Since the loans are to be CMHC insured, approval of the loans, in the form of an undertaking to insure, must be issued by CMHC. Approval must be obtained before construction begins. This differs from the practice of private mortgage insurance companies where approval may be requested before construction begins, during construction, or after completion.

Once construction begins, a series of inspections is carried out by CMHC. Each inspection is typically followed by an advance of funds from the lender to the borrower.[5] Advances are made to builders in such a way that sufficient mortgage funds are held back to complete the construction of the property. The final advance is held back by the lender until the property has passed a final inspection and has been sold to a home owner who is acceptable to the lender and CMHC

3. This can be done at any time of the year. However, the end of a year or the beginning of the next is most desirable because that is when the lenders know what the coming year's allocations are likely to be.

4. A *draw* is one of a series of loan advances received by a builder or developer against a specified total loan amount.

5. CMHC perform their own inspection on all mortgages they insure. Private mortgage insurance companies, with the exception of occasional spot checks, allow the approved lenders to carry out their own inspection before loan advances are made.

and who has acquired the title and assumed the mortgage. Throughout this process, a lawyer is retained to make certain that no claims are registered ahead of the lender and that advances are made only when construction has progressed satisfactorily. During construction or when the home is completed, a potential buyer approaches the builder. The salesman for the builder generally ascertains the credit worthiness of the buyer in an attempt to match the house and its payments with the credit capacity of the individual. If the buyer's credit worthiness appears established, the builder forwards an application for an Agreement of Sale to the financial institution that originally agreed to provide the mortgage funds. If the buyer is acceptable to the financial institution and CMHC,[6] the home is sold and transfer of title takes place.

ORIGINATION OF A PRIVATELY INSURED MORTGAGE ON AN EXISTING HOUSE

An existing house is eligible for an NHA insured loan or a conventional loan which is either insured or not insured. We have chosen to illustrate the creation of a privately insured loan. The reader should consult Exhibit 4-2 while reading this section.

In this example, the owner decides to sell his home for $40,000. The home has an existing seven percent conventional mortgage with an outstanding balance of $7,641 and a remaining term of eight years. The owner may sell privately or, as in our case, may use a real estate agent. The real estate agent attempts to find a buyer in return for a fee paid by the vendor of five percent of the selling price. The agent locates a potential buyer who is prepared to make a down payment of $2,000. As we will see later, this individual must also have additional funds available to pay for such items as a title search and taxes. At this point an *Agreement to Sell and to Purchase* is drawn up by the real estate agent and is signed by the buyer and seller. This agreement normally stipulates that the purchase offer is void unless adequate financing becomes available. The period that can elapse before the offer becomes void depends on local conditions and the practices of local real estate boards.

Assisted by the real estate agent, the purchaser begins to search for an appropriate means of financing the acquisition. As indicated in Exhibit 4-2, the purchaser could take over the $7,641 first mortgage and raise another $30,359 from a second mortgage lender. However, the second mortgage loan amount is quite high and the payments excessive, so the buyer considers a new first mortgage. A conventional mortgage loan is normally limited to 75 percent of the value of the property. Since the purchaser does not have adequate equity to finance the down payment, he must arrange a mortgage with a higher loan to value ratio. This

6. In practice, the private mortgage insurance companies and CMHC authorize approved lenders to approve the granting of the mortgage loan if certain income, loan to value ratio and other criteria are met.

Origination of a Privately Insured Mortgage on an Existing House — **Exhibit 4-2**

Owner decides to sell	The property was built in 1961 and was purchased for $18,000 on a conventional mortgage for $13,500 at 7% for a 20 year full amortized term (monthly payments $112.58 + taxes).
Real estate agent retained	Selling price $40,000. Remaining term on mortgage 8 years. Amount outstanding $7,641.
A buyer is located	He is prepared to make a $2,000 down payment.
Agreements to sell and to purchase are drawn up and signed on condition that financing is available. Buyer places a $500 deposit with the agent	Choices of Financing

Choices of Financing
- Refinance
  - NHA — Mortgage too high to be financed under NHA.
  - Insured High Ratio
  - Conventional — Would require $10,000 down payment.
- Take over first mortgage. Would require second mortgage of $34,141. Can only get 2nd mortgage at 3% above conventional mortgage rate. Decide to refinance.

Buyer is advised to approach an approved lender for an insured high ratio mortgage	
Lender has the buyer complete a mortgage application	
Lender sends out appraiser to property	The buyer pays an appraisal fee of $60.
Lender begins credit check on borrower	
Credit worthiness is established	
Lender reviews all information and decides he is prepared to make a loan of $38,000	The loan amount is $38,000 amortized over 25 years with a 5 year term and interest rate of 9½%.
Appraisal forms are completed and sent with application for insurance to private mortgage insurance company	The buyer pays an application fee of $20.
Insurance company returns commitment to insure for fee of 1%	They undertake to insure $38,000 for a total premium of $380.
The lender approves the loan and sends the commitment letter to the borrower	
The mortgage documents are drawn up	Legal fees paid by buyer.
The sale is finalized	Balance of down payments of $2,000 is made.
Mortgage payments begin and the new owner takes possession	Monthly payments $330.50 + taxes.

type of mortgage is possible only if it is insured. Since the amount of the mortgage exceeds CMHC limits, an NHA insured loan is not possible.[7] He, therefore, approaches an approved lender for a conventional high ratio loan.

The lender has the buyer complete a mortgage application form, interviews the borrower, does a credit check and has the property appraised. All appraisals are carried out by the staff of the lending institution or by hired appraisers. This differs from the CMHC procedure where CMHC does the appraisal. All appraisal and legal fees are paid by the borrower. The lender, after getting all information together, reviews it and makes a decision to lend $38,000 at 9 1/2 percent on a five year term and amortized over 25 years. He then sends the application to a private mortgage insurance company. Experienced mortgage underwriters on the staff of the mortgage insurance company review the submission and, if it is acceptable, a commitment to insure is issued to the lender. The premium charged for this insurance is one percent of the amount of the mortgage. It is added to the loan and is paid by the borrower over the amortization period. At this point, the financial institution searches the title, issues a loan commitment letter to the borrower and instructs its solicitor to have the mortgage documents drawn up. The sale is then finalized and mortgage payments begin.

ORIGINATION OF A SECOND MORTGAGE ON AN EXISTING HOUSE

A second mortgage loan is often useful in arranging a house purchase. Exhibit 4-3 illustrates the creation of a second mortgage on a single family house. In this case, it is assumed that an owner decides to sell his house for $28,000. There are 17 years remaining on the existing first mortgage and the amount outstanding is $14,537. The interest rate is 6 1/4 percent.

The real estate agent locates a buyer who has $4,000 available for a down payment. An Agreement to Sell and Purchase is drawn up on the condition that financing will be made available. At this point, the buyer is approximately $10,000 short after taking account of his down payment and the first mortgage. He has a choice of either refinancing the existing home at a relatively high current interest rate, or taking over the first mortgage and supplementing it with a second mortgage of $10,000 at 12 percent. Because of the low rate on the substantial first mortgage, a combined first and second mortgage financing arrangement has a lower interest rate than the refinancing option.

A variety of sources of second mortgage loans are available. The real estate agent may advise the potential purchaser to contact a finance company. Another option is to consult a broker or lawyer who, in turn, would find private sources of funds. A third alternative is for the seller of the home to take back a vendors second mortgage. We have assumed that a finance company is contacted. The finance

7. CMHC limits are subject to change and by the time of publication they may not act as a constraint in a case such as this.

Origination of a Second Mortgage on an Existing House **Exhibit 4-3**

Owner decides to sell	The property built in 1965, then valued at \$20,000, owner took an NHA mortgage for \$17,600 at 6¼% for a 25 year fully amortized term. (Monthly payments \$116 — include insurance premium and taxes).
Real Estate agent retained	Selling price \$28,000. Remaining term on existing first mortgage 17 yrs., amount outstanding of \$14,537.
A buyer is located	He has \$4,000 available for a down payment.
Agreements to sell and to purchase are drawn up on condition that financing is available. A deposit of \$500 is taken by agent	Choice of Financing

Choice of Financing:

- Take over 1st mortgage. Add second mortgage of \$10,000 at 12%. Average interest rate 8½%.
- Refinance Current Rate 9¼%

Purchaser approaches a finance company	
Finance company establishes credit worthiness	
Finance company has the property appraised	Purchaser pays appraisal fee \$50.
Finance company approves the loan	
A second mortgage document is drawn up	\$10,000 at 12%, open term, amortized over 15 years. (monthly payments \$118) Legal fees are paid by borrower.
The seller notifies the first mortgage lender of the transfer	
The sale is finalized	Remainder of down payment of \$3,463.
Mortgage payments begin and the new owner takes possession.	Total monthly payments \$234.

company establishes the credit worthiness of the borrower, has the property appraised and the title searched. All out-of-pocket costs are paid by the borrower. If the credit check is favourable, the finance company approves the loan and a second mortgage document is drawn up. In return for finding this customer, the finance company would perhaps pay a fee to the mortgage broker or real estate agent.

ORIGINATION OF AN NHA MORTGAGE ON AN APARTMENT BUILDING

Thus far, we have outlined the origination of mortgages on single family houses. In this section, the origination of a mortgage on an apartment building is discussed. This process is illustrated in Exhibit 4-4.

A developer arranges to have serviced land made available for the construction of an apartment building. The developer may be constructing the building for resale[8] or for rental income purposes. In some cases, a development group is formed consisting of a land developer, a builder and a long-term investor. The long-term investor, which may be a life insurance company or a pension fund, is often willing to take both a debt and an equity position.[9] Some investors, wishing to take an equity position, will propose a land purchase and leaseback arrangement. The investor purchases the land and leases it back to the builder who in turn constructs a building on the site. The investor often provides *long-term* financing for the structure as well. As a result of this arrangement, the investor derives a suitable return on his investment in the land and the owner of the building derives income from rentals without making any capital outlay for land. At the end of the contractual period, the land, which will presumably increase in value, can be sold by the institutional owner, thus providing a capital gain without going through the difficulties associated with the ownership and disposal of the building itself.

Plans for a 285 unit apartment building are drawn up and permission to proceed is obtained from the municipality. At this point, the developer approaches an NHA approved lender asking that the lender provide all of the mortgage financing or that the lender locate other investors who will provide the funds. An alternative procedure is to have a mortgage broker assist in the preparation of a proposal which can be presented by the broker to various lenders for their consideration.

At this stage, an application is made to CMHC for an *Advice of Loan Amount*. This is an indication by CMHC that, if the developers provide complete plans and apply for an Undertaking to Insure the property, CMHC will insure a loan

8. A firm that constructs buildings for resale is called a *merchant builder*.

9. For example, the Alberta Government Telephone Pension Plan has invested $2.36 million in a Calgary development, consisting of an $860,000 loan to the developer, $1 million for a one-third equity position, and $500,000 for land ownership. See "Funds Invested", *The Globe and Mail*, Toronto, January 15, 1974.

Origination of an NHA Mortgage on an Apartment Building — **Exhibit 4-4**

Developer buys serviced land zoned for high rise development.	Cost of land $750,000		
Plans drawn up and planning permission obtained	Estimated total cost of project $4 million. 285 Unit block.		
Developer approaches approved lender.			
CMHC approached for an Advice of Loan			
Advice of Loan issued	loan amount	$3,250,000	
	insurance	40,625	
		3,290,625	
	interest	9.75%	
	35 yr. amortization period closed for 25 years.		
Approved lender finds four investors who are prepared to make advances	Investor A Pension Fund		$1,000,000
	Investor B Pension Fund		750,000
	Investor C Small Trust Co.		540,625
	Investor D Life Insurance Co.		1,000,000
			$3,290,625
Investors indicate where servicing is to go up			
Commitments are signed			
Formal application for insurance is made to CMHC through the approved lender			
An Undertaking to Insure is issued by CMHC			
Developer arranges a line of credit at bank to use until he can make the first draws on the mortgage	Line of credit $300,000.		
Construction begins			
The mortgage is drawn up			
Inspection of construction made by CMHC. Permission given for first advance.			
First advance made by lenders	First advance $500,000.		
Developer uses part of the first advance to reduce his bank loan			
Inspection and advances are repeated until the property is completed, rental begun and final takedowns made			
Monthly payments by developers are begun			

of a specified dollar amount. The Advice of Loan Amount is good for sixty days and must be applied for by an approved lender. There is an implication that the approved lender is making the loan itself but the application may be put forward as a service to a broker or a group of non-approved lenders. In return for this assistance, the approved lender may be granted the servicing[10] associated with the project.

In our case, an Advice of Loan Amount is issued by CMHC in the amount of almost $3.3 million and with an interest rate of 9.75 percent. The loan has a 35 year amortization period and is closed to repayment for 25 years. This type of mortgage is also made with a five year term at the request of investors such as trust companies.

Four investors are willing to place funds in this apartment project. The lenders are probably small institutions; otherwise one institution would probably make the entire mortgage loan itself. These joint mortgage arrangements can be quite complex. It is common for investors to have different investment objectives, all of which must be accommodated in the mortgage agreement. Also, if one of the original partners in the venture wants to sell his portion of the project, it is sometimes difficult to accomplish.

At some point, the investors must decide who will service the mortgage and must pay any brokerage charges to the various parties who brought the buyers and sellers together. At the same time, two kinds of commitments are signed. The first commitment is between the investors and the approved lender, indicating when the investors will pay funds to the approved lender, the servicing fee to be paid and the nature and timing of required reports. This agreement may be in the form of a take out commitment upon completion, or a series of payments based on the progress of construction. A second commitment is made between the approved lender and the builder, indicating at what stage of the construction advances are going to be made and how much each of the advances will be. This latter commitment is, in fact, the mortgage contract.

Formal application for insurance is made to CMHC through the approved lender and if everything is in order, an Undertaking to Insure is issued by CMHC. CMHC charges an insurance fee of 1 1/4 percent or, in this case, approximately $40,000. Although we have assumed that CMHC performed the insurance function, the apartment building could have been insured by a private insurance company.

After construction has begun and the mortgage document drawn up, a series of inspections take place after which advances occur. The developer employs part of these advances to reduce the amount of the bank loan or other interim financing outstanding. On the date specified in the mortgage document, at which time the building is complete and rented, monthly payments against the mortgage are begun by the developers.

10. *Servicing* a mortgage is the activity associated with administering the mortgage loan and consists of collecting the payments, keeping records, verifying that the property is insured against hazards and so on. In return for these activities a *servicing fee* is charged.

Chapter 5

Mortgage Insurance

This chapter outlines the mortgage insurance programs of CMHC and a number of private mortgage insurance firms, including the details of the programs available, administrative procedures and the attitudes of lenders toward the choice of an insurance program.

ACTIVITIES OF CMHC

The Central Mortgage and Housing Corporation (CMHC) was created in order to administer the National Housing Act (NHA). One part of the NHA provides for a mortgage insurance program.[1] CMHC is given the right to insure repayment of any loans which qualify under the National Housing Act. CMHC will guarantee a lender in advance that it will issue an insurance policy if the loan is made in accordance with the Act. The lender may insure all progress advances or just the fully advanced loan amount. In the event that a borrower defaults on the loan, CMHC guarantees to pay an insurance settlement to the lender.

If default on the mortgage occurs, and the title to the property along with any additional security taken has been conveyed to CMHC, the corporation will pay to the lender the total of the following amounts:[2]

- the principal amount owing on the mortgage as at the date of the commencement of foreclosure proceedings or the date of acquisition;
- any approved borrowers' charges;
- interest at the mortgage interest rate on the principal owing for the period during which the loan was in default or a period of 12 months, whichever is shorter;
- interest at the mortgage rate less two percent for a maximum period of six months in addition to the first 12 month period; and
- any reasonable amount approved by CMHC for the legal costs of acquisition when making a claim.

1. *National Housing Act*, S.C. 1953-54, c. 23, s.1. pp. 5342-5353.

2. *Ibid,*

Provision is made in the Act for CMHC to make a settlement with the lender without foreclosure as long as all rights and security on the loan are transferred to CMHC.

All applications for mortgage insurance and all servicing of NHA mortgages must be done through *approved lenders.* Approved lenders have certain other privileges under the Act. For example, they are the only institutions that may act as agents for CMHC in the making or administration of NHA loans and are the only institutions that may borrow from CMHC using insured loans as security. To be an approved lender, an institution must apply to CMHC who examine the applicant's paid up capital, nature of business, and its ability to administer mortgages, including the qualifications of personnel and financial strength. A list of approved lenders includes most of Canada's insurance companies, loan companies, trust companies and banks. Although they have been mortgage lenders for some time, credit unions are quite new to the list of approved lenders. Finance companies normally do not apply to become approved lenders while pension funds typically do not qualify. Pension funds normally rely on other financial institutions to originate and service their mortgages but some of the larger funds provide their own originating and servicing facilities.

CMHC will insure first mortgage loans made by approved lenders for the construction of a house, cooperative housing project, rental housing project or condominium. It will also insure first mortgage loans on existing houses and condominium units to facilitate purchase or improvement of the property.[3] Insured loans on vacation homes may be made only if the home is the principal residence of the owner and capable of being occupied year round. There is no provision for the insurance of commercial or industrial properties unless they are a part of a residential structure; even in these cases, the commercial or industrial portion of the insured loan is severely limited.

When a lender wishes to insure a loan on a newly constructed property, he must first apply to the local CMHC office for an *undertaking to insure* which stipulates the terms and conditions under which CMHC will insure the loan. CMHC refuses to issue an undertaking to insure if construction of a single family home or a duplex has passed the first floor joist or sub-floor stage of construction; in the case of rental properties no work other than the excavation may have taken place. At the time of application, the plans are checked to ensure that they conform to the housing standards as developed by the National Research Council and expressed in the Canadian Code for Residential Construction which is derived from the National Building Code.

Mortgage loans for new properties may be made on an instalment basis or a completion basis; instalment or progress draws may be insured or uninsured. As construction of the property proceeds, CMHC makes a series of mandatory inspections to ensure that the property complies with the standards set out by CMHC. (Inspections are often carried out by the municipality and the approved

3. In certain cases of financial hardship, encumbrances on an existing house may be refinanced.

lender as well.) If, as a result of inspection, it is determined that the structure does not comply with CMHC standards, CMHC can instruct the lender to stop further insured progress advances or can refuse to insure the property on completion until such time as the deficiencies are corrected. In the case of uninsured progress advances, the lender has the option to make the advances or wait until the structure is up to standards. Any deficiencies found during inspections usually have to be corrected for the next inspection. In some cases CMHC may waive an infraction; this is done if there is no way that it could easily be corrected and yet is relatively minor. From the lenders standpoint, it is essential that the property meet all CMHC and municipal government standards.

The appraisal and inspection of new and existing properties is an integral part of the CMHC approval procedure. The amount of a loan which CMHC will undertake to insure depends on the value of the land and the proposed building. An appraiser's guide is published by CMHC head office but the costs for an average house are determined locally. The local cost per square foot for a standard house is used as a basis for appraisal and adjustments are made for any extras or differences between properties. Rental properties are valued on an income basis as well as a cost basis.

The regulations to the National Housing Act have for many years specified the maximum loan amount that a borrower can receive. In recognition of the gradually increasing cost of housing, this Canada wide maximum loan amount was increased several times; in October 1973 it reached a level of $30,000 for a single family house and $20,000 per unit for rental housing. Throughout the remainder of 1973 and early 1974, it became apparent that the maximum loan amounts permitted on NHA loans were inadequate to finance the increasing costs of Canada's housing. It was also noted that housing costs varied significantly between regions. In an effort to meet this need for higher and more flexible loan limits, the maximum loan amount was increased across Canada in June of 1974 but was, for the first time, made larger in some regions than others. These regional maxima have since been revised twice and are expected to be reviewed each quarter.

On single family properties, the loan may not exceed 95 percent of the first $42,105 of lending value plus 75 percent of the balance up to the loan maximum prescribed for the market area. On multiple family (rental) properties, the loan may not exceed 90 percent of the first $44,444 of lending value plus 75 percent of the balance up to the market area maximum loan. Table 5-1 contains the maximum loan amounts by market area as of April 1, 1975.

The mortgage insurance fee on single family dwelling loans is one percent of the principal amount loaned if insured progress instalments are made and seven-eighths of one percent when the entire loan is advanced on completion.[4] In the

4. Some lenders make uninsured advances and charge the full one percent fee, remitting seven-eighths of one percent to CMHC on completion and retaining one-eighth of one percent in return for taking the risk of loan advances.

Maximum Loan Amounts for NHA Insured Loans on Single Family Properties by Market Area as of April 1, 1975

Table 5-1

Market area	Description	Maximum 95% NHA Loan	Maximum Lending Value for 95% Loan	Maximum NHA Loan	Lending Value for Maximum NHA Loan
Newfoundland					
St. John's	Census Metropolitan Area	40,000	42.105	44,000	47,438
Corner Brook	Town Limits	40,000	42,105	44,000	47,438
Labrador City	Town Limits	40,000	42,105	44,000	47,438
Wabush	Town Limits	40,000	42,105	44,000	47,438
Nova Scotia					
Halifax	Census Metropolitan Area	40,000	42,105	44,000	47,438
Quebec					
Hull-Ottawa	Census Metropolitan Area	40,000	42,105	46,000	50,105
Cote Nord	Counties of Saguenay and New Quebec	40,000	42,105	44,000	47,438
Ontario					
Toronto	Census Metropolitan Area	40,000	42,105	48,000	52,771
Hamilton	CMHC Hamilton Office Area (exclusive of Toronto CM Area)	40,000	42,105	46,000	50,105
Ottawa-Hull	Census Metropolitan Area	40,000	42,105	46,000	50,105
Kitchener	CMHC Kitchener Office Area	40,000	42,105	44,000	47,438
Oshawa	CMHC Oshawa Office Area (exclusive of Toronto CM Area)	40,000	42,105	44,000	47,438
Barrie	CMHC Barrie Office Area	40,000	42,105	44,000	47,438
British Columbia					
Vancouver	Census Metropolitan Area	40,000	42,105	48,000	52,771
Victoria	Census Metropolitan Area	40,000	42,105	46,000	50,105
Yukon		40,000	42,105	44,000	47,438
N. W. T.		40,000	42,105	44,000	47,438
All Other Market Areas		40,000	42,105	40,000	42,105

Source: CMHC, *Advice to Approved Lenders*, No. 478, April 15, 1975.

case of loans on existing property, the fee is seven-eighths of one percent payable at the time the loan is advanced. If repairs or alterations are necessary to bring the property up to standard, the fee is one percent. Rental loans require a fee of 1 1/4 percent for insured instalment loans and 1 1/8 percent on non-instalment loans. The insurance fee is added to the mortgage loan and is amortized over the full period of the mortgage.

When the approved lender submits an application for insurance on behalf of a potential homeowner, he has to provide information on the borrower's income. The ratio of the gross debt service charges to the borrower's income is called the *gross debt service (GDS) ratio.* A generally accepted maximum GDS ratio is 30 percent and lenders may approve cases where the ratio is 30 percent or less without prior approval from CMHC. Where a potential borrower has a gross debt service ratio in excess of 30 percent, the lender may still recommend to CMHC that the loan be approved. Generally, such approval would require evidence that the borrower's financial condition and earning prospects were adequate to enable him to make the mortgage payments despite the fact that the GDS ratio exceeded the normal limits.

At the present time, the interest rate charged by the lender on a CMHC insured loan is a market determined rate. This was not always the case. The evolution of the so-called "NHA rate" is discussed at length in Chapter 3.

PRIVATE MORTGAGE INSURANCE COMPANIES

Until 1970, most institutional lenders were permitted to invest in mortgage loans up to 75 percent of the appraised value of the property unless the loans were insured by CMHC. In 1970, the federal legislation was extended, permitting institutional lenders to invest in mortgage loans in excess of 75 percent of the appraised value of the property provided that the excess was insured by a private mortgage insurance company or the government of a country, province or state in which the mortgage was issued. In the period 1971-73, most of the provinces passed parallel legislation permitting provincially chartered companies to make privately insured high ratio mortgages. These changes in legislation led to an increase in the activity of the only private mortgage insurance company operating in Canada at the time and contributed to the creation in 1972 of two others; the three companies are the Mortgage Insurance Company of Canada (MICC), the Sovereign Mortgage Insurance Company (Sovereign) and the Insmor Mortgage Insurance Company (Insmor).[5] As indicated in Table 5-2, MICC is presently the largest of these firms.

5. Private mortgage insurance has been used for a longer period and more extensively in the United States. For a good discussion of private insurance in that country, see C. Rapkin, *The Private Insurance of Home Mortgages*, Guaranty Insurance Corporation, 1973.

Financial Highlights of Canada's Three Mortgage Insurance Companies for the Year Ending December 31, 1974

Table 5-2

	MICC	**Insmor**	**Sovereign**
Number of Loans Insured	51,741	10,743	9,721
Dollar Value of Loans Insured ($ million)	1,960	600	274
Net Earnings ($ thousands)	5,695	842	701
Total Assets ($ millions)	89	22	14

Source: MICC Investments *Annual Report,* December 1974; Sovereign Mortgage Insurance Company *Annual Report,* December 1974; and Insmor Mortgage Insurance Company, Press Release, April 14, 1975.

The Mortgage Insurance Company of Canada is a federal company which was incorporated in December 1963.[6] From 1964 to 1970, the primary activities of MICC related to the insuring of joint high ratio loans made by selected institutional mortgage lenders and Central Covenants Ltd.[7] Following the legislative changes in 1970, the volume of mortgage insurance business done by MICC increased considerably. At approximately the same time, the firm introduced a program of lease guarantee insurance. Over 75 percent of the commitments issued by the firm in 1974 were for high ratio mortgages on single family houses. Sixty percent of the commitments were for new housing and 40 percent were for existing housing.

The Sovereign Mortgage Insurance Company is a private firm owned by Industrial Acceptance Corporation Limited, the Royal Trust Company, Canada Perma-

6. MICC Investments Ltd. (then called Holborough Investment Ltd.) was formed in 1963 by Aluminum Company of Canada, Shielding Limited and the Bank of Nova Scotia. It is now a public company with shares traded on the Montreal and Toronto stock exchanges. MICC Investments owns all of the shares of The Mortgage Insurance Company of Canada plus a 50 percent interest in Charlotte Properties Ltd., a vacation land development company. The major shareholders in MICC Investments Ltd. now include: Canadian Pacific Investments Ltd., the pension fund of Canadian National Railway Company, Canadian Enterprise Development Corporation, The Toronto Dominion Bank, The Bank of Nova Scotia, the pension fund of Air Canada, Mortgage Guarantee Insurance Corporation and The Bank of Montreal.

7. In 1963, Holborough Investments, a partnership of the Aluminum Company of Canada, Shieldings Limited and the Bank of Nova Scotia, initiated the formation of Central Covenants Limited. The original objective of Central Covenants was to make joint loans, along with approved lenders, to borrowers requiring high ratio loans. In 1969, Holborough Investments divested itself of all holdings other than its interest in the Mortgage Insurance Company of Canada and changed its name to MICC Investments Ltd. The Holborough interest in Central Covenants was distributed to its three shareholders in 1969; subsequently the Bank of Nova Scotia became a more significant shareholder in Central Covenants. The relationship between the Bank of Nova Scotia and this firm is discussed in more detail in Chapter 11. The breakdown of commitments in 1973 and 1974 is seen in Table 5-3.

Value of Commitments to Insure Made By MICC in the Years Ended December 31, 1973 and 1974 by Type of Commitment

Table 5-3

Type of Commitment	$ millions	
	1974	1973
High Ratio Loans	1,485	1,793
75% House Loans	112	28
High Ratio Apartment Loans	163	256
75% Apartment Loans	7	5
High Ratio Commercial & Industrial Loans	107	58
75% Commercial & Industrial Loans	81	52
Vacation Home Loans	4	6
Total	1,959	2,198

Source: MICC Investment Ltd., *Annual Report*, 1974.

nent Mortgage Corporation and Continental Illinois Corporation. The Company was incorporated in November 1972, insured its first loan in April 1973 and has since grown rapidly. During 1974, the firm restricted itself to the insurance of mortgages on single family dwellings, including condominiums: 34 percent in Western Canada, 54 percent in Central Canada and 12 percent in the Atlantic provinces. The major share of mortgages were on existing property. In late 1974, the firm began to insure apartment, commercial and industrial mortgages.

Insmor Mortgage Insurance Company is a private company which was incorporated in 1973 by a number of major Canadian financial institutions and commenced operations in April 1973.[8] Insmor initially insured only single family dwelling mortgages but by mid 1974 the firm had begun to make loans on apartment buildings and vacation homes.

ACTIVITES OF MICC

This section provides an overview of the mortgage insurance activities of MICC and compares them with CMHC. Although there are three private mortgage insurance companies, MICC was chosen because it is a public company and is the largest and oldest such firm currently operating in Canada. In addition, the operations of Sovereign and Insmor largely parallel those of MICC. Where substantial

8. The sponsors of Insmor were Banque Canadienne Nationale, Canadian Imperial Bank of Commerce, Canada Trust, Great West Life Assurance Company, Imperial Life Assurance Company, Montreal Trust, Prudential Assurance Company, Royal Bank, Royal Insurance Group, Trust General du Canada and Waltson Properties Limited.

differences exist they will be pointed out.[9] As a general rule, MICC has designed its regulations and procedures to broadly resemble CMHC but has tailored them to work easily with the procedures followed by lenders.

MICC differs from CMHC with regard to the types of properties insured. Whereas CMHC insures mortgages only on residential properties, MICC insures first mortgages on single family, duplex, triplex, condominium and apartment dwellings, vacation homes and commercial and industrial properties. Sovereign began insuring commercial and industrial properties in July 1974 while Insmor has concentrated on single family dwellings and has just begun to insure mortgages on apartment buildings and vacation homes.

The coverage provided by private insurance companies is different from that of CMHC which always pays claims in full and takes title to the property. MICC has two options it may use in settling claims. Under Option A, MICC, upon completion of foreclosure and delivery of title to the property, will pay:

- the unpaid principal of the loan;
- all charges for taxes, fire insurance and public utilities;
- interest at the mortgage rate on the above until the date of the claim[10];
- legal fees and costs associated with foreclosure; and
- reasonable costs of maintaining the property.

Under Option B, the lender retains title to the property and MICC pays 25 percent of the sum computed under Option A to the lender.[11] In the case of mortgages on houses, duplexes, triplexes, and vacation homes, where the loan to value ratio does not exceed 75 percent, Option A always applies; in other cases, MICC may elect either option. All claims to date have been paid under Option A.

Like CMHC, MICC has a substantial number of approved lenders who are the only lenders allowed to originate and service MICC insured loans.[12] When the mortgage loan is advanced to a builder in the form of instalments the lender is

9. Much of the information in this section was obtained from the approved lenders operating manuals for the three insurance companies: MICC, Sovereign and Insmor.

10. In addition, interest at the mortgage rate is paid on the full amount of the lender's claim from the date of the claim to the date of payment or for a period of 90 days, whichever is less.

11. More accurately the payment is 25 percent in the case of high ratio mortgages on single family, duplex, triplex and vacation homes; the payment is 20 percent in the case of mortgages on rental properties containing four or more rental units and commercial and industrial mortgages.

12. Almost all of the NHA approved lenders are also MICC approved. Most of them have a lengthy history of successful mortgage lending, a characteristic which is essential to the operation of a mortgage insurance program since the lender does the bulk of the evaluation. Sovereign and MICC normally operate with approved lenders under a blanket policy whereas Insmor does not "approve" lenders. Instead, they receive a proposal and issue a policy for every insured mortgage.

responsible for all inspections; similarly, when a loan is made for an existing property the appraisal is the responsibility of the approved lender. This procedure differs from CMHC which supplies the inspectors and appraisers. From time to time, MICC has secured fee appraisals on a sampling of its mortgage applications and has made field inspections on a limited basis. In November 1973, MICC announced its intention to add a chief inspector and regional inspectors to its staff for purposes of carrying out spot check house inspections and assisting lenders with queries. Inspections were to be concentrated on those builders whose quality of workmanship was not as good as others, while good quality builders would receive a minimum of inspection. In addition, the firm embarked on a series of construction inspection seminars for lenders across the country.

As indicated previously, CMHC has a maximum insured loan amount on single family properties that varies by region. MICC has no maximum on single family homes but has a sliding scale for loan to value ratios as seen in Table 5-4.[13] In response to a Federal government request, MICC voluntarily imposed limits on

Maximum Loan to Value Ratios and Maximum Loan Amounts for MICC Insured Loans as of July 1974 **Table 5-4**

Single Family and Duplex	95% of loan value to $40,000 plus 75% of loan value for next $20,000 plus 50% of loan value over $60,000
Triplex	90% of loan value to $40,000 plus 75% of loan value for next $20,000 plus 50% of loan value over $60,000
Vacation Homes	80% of value
Maximum Loan Amount	$30,000
Rental*	85% of loan value
Apartment Building	$15,000 per unit
Row and Town Housing	$18,000 per unit
Maximum Loan Amount	$4,000,000
Commercial and Industrial	
Maximum Loan Amount*	$4,000,000

* In recognition of rapidly rising costs, MICC, in the fall of 1974, removed the per unit maximum on rental properties and increased the maximum loan amount on rental, commercial and industrial properties to $6 million.

Source: Mortgage Insurance Company of Canada, *Approved Lender Manual,* August, 1974

13. For Sovereign the loan to value ratios are approximately the same but the maximium loan amount on multiple family residential, commercial and industrial loans is $2 million.

loan amounts as a temporary measure in the summer of 1974.[14] These limits were removed on November 19, 1974 following the Federal government's budget.

Insurance fees charged by CMHC are somewhat lower than those of MICC; an outline of these fees is seen in Table 5-5. CMHC does not insure commercial and industrial mortgages.

Premiums Charged on Loans Insured By MICC, as of August 1974 (Percent) — **Table 5-5**

		High ratio (in excess of 75% loan to value ratio)	Conventional (75% or less loan to value)
Single family, duplex, triplex		1.0	0.6
Rental (4 or more units)		1.5	1.0
Vacation Homes		2.0	2.0
Commercial and Industrial:			
Amortization	**Term of Coverage**		
up to 20 years	10 years	2.25	1.5
21-25 years	10 years	2.5	1.75
up to 20 years	15 years	2.5	1.75
21-25 years	15 years	2.75	2.0
up to 20 years	20 years	2.75	2.0
21-25 years	20 years	3.0	2.25

Note: All residential mortgage insurance coverage is for 20 years and there is no extra premium if progress advances are insured. For commercial and industrial insurance, the premium is increased by one-quarter of one percent where progress advances are insured.

Source: Mortgage Insurance Company of Canada, *Approved Lender Manual,* August, 1974

THE DECISION TO INSURE

When a lender is faced with a loan request by a borrower, he must decide between an uninsured or insured mortgage. For single family properties, the loan to value ratio appears to be the determining factor. If the loan requested is for an amount in excess of 75 percent of value, the excess must be insured. When the loan requested is for an amount less than 75 percent of value, it is not usually insured, although there appears to be some developing interest in the insuring of

14. In an effort to provide more funds for low cost housing, the Federal government requested that lending institutions and mortgage insurance companies limit loan amounts based on price and income levels in various areas across the country. The price and income levels were similar to those adopted by CMHC. Thus, MICC temporarily changed the ratio on single family and duplex loans to 95 percent of the first $32,000 of value plus 75 percent of value in excess of $32,000. On triplex loans, the ratio was 90 percent of the first $32,000 of value and 75 percent of the value above $32,000.

such investments. This interest is caused by general economic uncertainty, the relatively low premium and the feeling that insured 75 percent loans would be easier to sell in the secondary market.

The lender does not rely exclusively on mortgage insurance to protect against excessive risk. In fact, most lenders are quite risk adverse and try to avoid the difficult and lengthy procedures of foreclosure. As a result, the lender tends to avoid what is perceived as a risky loan even if mortgage insurance should happen to be available.

In commercial, industrial and some apartment loan situations, insurance becomes important protection against risk even if the loan does not exceed 75 percent of value. Because insurance will make the loan more palatable to an investing client or lending committee, the lender takes out mortgage insurance. Lease insurance is sometimes used for this same purpose. Of course, any lender would say that it is poor lending practice to use insurance as an alternative to good underwriting principles.

PRIVATE VERSUS GOVERNMENT INSURANCE

During the course of this study, a number of the respondents indicated a preference for either NHA insured mortgages or privately insured mortgages. Since MICC was essentially the only private insurance company operating at that time, the content of this section is an examination of the pros and cons of using NHA insurance versus MICC insurance. The two sources of insurance may be compared along a number of dimensions.

Method of settlement: CMHC pays a mortgage claim in full while MICC retains the option to pay in full or pay part of the principal and leave the property in the hands of the lender.[15] The second option used by MICC is perceived by lenders to be unattractive for two reasons. First, in spite of the fact that the mortgage is insured, the lender could potentially lose a significant amount of money in the event of default. Second, lenders are generally not interested in taking over the property and going through the procedure of trying to recover their funds. However, as noted above, this option has never been utilized. It may be eventually eliminated as private insurance companies continue to grow.

Maximum single family amount: As outlined earlier, CMHC has set limits on the amount insured for any given house; MICC under normal circumstances has no such limit. MICC's willingness to provide insurance on single family homes in greater amounts is a significant competitive advantage over NHA insurance. This applies particularly in high price urban areas such as Toronto and Vancouver where the CMHC maximum is below average house prices. It was the policy of the local branch of at least one bank that was interviewed to employ NHA Mortgages wherever possible up to the NHA limit and then employ privately insured

15. When the mortgage is on a house, duplex, triplex or vacation home and the loan to value ratio does not exceed 75 percent, the first option is always used.

mortgages in any other high ratio loans. MICC has indicated, however, that high ratio loans are seldom used for houses valued in excess of $65,000.[16]

Maximum allowed for large projects: CMHC will insure 90 percent of value and up to $20,000 per unit for rental housing while MICC will insure 85 percent of value with a maximum loan amount of $6 million. CMHC has no maximum loan amount. Because of the relatively low limits of private insurers, most of the large apartment complexes tend to be NHA insured loans. Over the last few years, MICC has gradually increased its maximum loan amounts to become more competitive.[17]

Speed of approval: Most institutions interviewed felt that an NHA insured loan took longer to be approved than a privately insured loan. There are several reasons for this. One is the fact that CMHC does its own appraisals whereas private insurance companies require the lenders to do this. Also, CMHC goes to great lengths to ensure that the property corresponds to the National Building Code and a variety of CMHC requirements whereas the private insurer usually leaves the task of determining compliance with standards, plans and specifications to the municipality and the approved lender. It should be noted, however, that MICC has recently instituted inspections on a sampling basis. Another reason for this difference is that in recent years house building activities have been at record levels which produced an unexpected backlog in the workload at local CMHC branches.

Appraisal and Inspection: CMHC charges $35 for their application which includes an inspection of plans, an appraisal of the property and a commentary on the suitability of the land. Where private insurance is used the appraisal and inspection fee is higher. The application fee payable to the private mortgage insurer on single family properties is usually $20.00 and the appraisal performed by the lender normally costs $50.00 to $100.00.

CMHC is considered by some lenders to give lower appraised values on property than do their own or independent appraisers. A higher appraised value permits the borrower to obtain an insured loan representing a higher proportion of the selling price of the property and helps builders to attract more customers. Of course, any lender or mortgage insurance company would be unlikely to accept an appraised value which exceeded the selling price.

The inspection activities of CMHC are of special concern to some builders. It is generally acknowledged that the enforcement of standards by CMHC is more rigid than most lenders. From the builder's standpoint, enforcement of rigid standards results in completion delays and, even more important, results in the delay of mortgage draws. It has been claimed that CMHC uncovers relatively

16. In 1974, of all commitments made by MICC to insure single family home mortgages, only four percent had a value in excess of $50,000.

17. See "MICC Liberalizes Stand on Insurance Loans for Major Rental Projects," *Canadian Building*, May 1973.

minor faults in their inspections. Until these faults are corrected, CMHC can refuse to issue Advance Certificates and have the lending institution withhold disbursement of mortgage funds. Many of these problems can be avoided by the use of private insurance because enforcement of building standards is the responsibility of the lender and the municipal government who often take a more flexible approach.

From the lenders point of view, CMHC inspection activities are looked upon favourably since lenders may not have staff to carry out this function and they can have somewhat more confidence in the quality of the structure. Some lenders expressed concern that the growing emphasis on privately insured mortgages may lower the quality of housing in general because the lending institutions cannot or will not follow up on the quality of building as well as CMHC does. It is generally thought, however, that if a builder produces a significant amount of inferior housing he will soon find it difficult to raise mortgage funds and this would act as a major constraint on him. In view of a rapidly growing volume of business, and perhaps in recognition of some of these concerns, MICC decided to proceed with the establishment of a construction inspection department in 1973. The Federal government and builders associations may also have been influenced by these factors in arriving at a decision to propose a national house warranty plan.

A house warranty plan was first proposed by the Housing and Urban Development Association of Canada (HUDAC) and presented to the Federal government in July of 1973. It was proposed that for $80 the homeowner would receive inspection, insurance and conciliation services for five years. The plan was to be administered by a non-profit corporation controlled by HUDAC with a board of directors consisting of builders, government and other interested parties. Mr. Basford, then the Minister of Urban Affairs, made a counter-proposal that entailed a government-run National Home Warranty Council which would set up a standard builders' warranty, provide insurance against failure by the builder to complete the house or comply with the warranty, set up a simple system of arbitration and register builders with the Council.[18] This plan was rejected by HUDAC basically because it removed control of the plan from the builders.[19] A new plan was proposed by HUDAC but it was opposed by the Federal government.[20] In the meantime, the provinces began to push for their own versions of a warranty program. This raised fears that there be several provincial warranty plans and a federal plan which applied only to federally incorporated institutions such as CMHC and the private mortgage insurers.[21]

18. See "House Warranty Plan Proposed by Basford," *The Globe and Mail*, Toronto, February 5, 1974.

19. See "Hudac Says No to Ottawa," *Financial Times*, Montreal, February 11, 1974.

20. See "House Warranty Plan Meeting Opposition," *The Globe and Mail*, Toronto, August 2, 1974.

21. For a discussion of the evolution of this debate, see R.T. Ryan, "Warranty Insurance Protection Plan," *Toronto Home Builders' Association News*, July 1974.

Recent announcements by HUDAC and the Federal government indicate that chances have improved for a federal plan. In the meantime, the HUDAC Council in Alberta is expected to have their plan operational soon. If some form of warranty is finally adopted, it will benefit homeowners as well as private mortgage insurance companies and lenders due to the enhancement of the underlying value of the mortgaged property. However, another implication is that such a plan will probably add to the cost of housing.

Insurance fees: The insurance fee charged by MICC is somewhat higher than that charged by CMHC although MICC has recently been making moves to become more competitive in this area. This is partly due to the entry of new private insurance firms into the business.[22] Generally speaking, when a lending institution is determining the type of insurance to obtain for a mortgage, the insurance fee is not a major factor. This is probably because it is the borrower who ultimately pays the insurance fee and not the lending institution itself. It may also be because the lending institution is, within good credit practices, attempting to obtain the maximum amount of financing possible for its customer and that becomes the more important criterion.

The present premium charged for mortgage insurance does not appear to be closely related to the default levels in total or of particular classes of loans. Perhaps when the private mortgage insurance companies have more experience with large volumes of insured loans, they will have larger reserves, and will be able to compete head on with CMHC in setting fees.

Flexibility: If the builder of an apartment block begins building before he has a Commitment to Insure, he risks not receiving approval from CMHC; MICC appears to be more flexibile in this regard. Moreover, CMHC must adhere closely to its lending limits whereas MICC has some latitude to change or make exception to company policy on fairly short notice.

Ownership of insurance companies: As indicated earlier in this section, the private mortgage insurance companies are owned primarily by institutions who originate mortgages and firms that invest in mortgages. Several of these institutions have indicated that the factors discussed above are important in determining whether a loan should be insured by CMHC or a private insurance company. However, once the decision to use a private insurance company is made, the lenders emphasize their affiliate.

22. See "MICC Lowering Mortgage Insurance Premiums as Competition Increases," *Canadian Building*, January 1973.

Chapter 6

Second Mortgages

Although this study focuses mainly on first mortgages, it is important to remember that second mortgages are frequently used in the financing of real estate. This chapter briefly outlines the demand, supply and financial characteristics of second mortgages.

THE DEMAND FOR SECOND MORTGAGES

A *second mortgage* is a loan secured by a claim against real property which ranks behind the first mortgage claim on the same property. The need for second mortgages can arise in several ways, four of which are mentioned below.

A second mortgage may be created when a person wishes to improve his property, for example, by building an additional room. It may also be created as security for a *consolidation loan*. An individual with a first mortgage on his property may make a series of small loans for such items as boats, vacations and so on. These small loans can eventually place the homeowner in payment difficulties. In response to this problem, the financial institution may consolidate all of these payments into a single larger loan with a longer amortization period and secured by a second mortgage. This longer amortization period makes it easier for the borrower to make the required monthly payments.

Second mortgages most commonly originate when the seller of a home agrees to hold a second mortgage on the property in order to facilitate sale to a buyer who requires additional financing beyond the first mortgage. This type of mortgage is called a *vendor take back mortgage*. The vendor retains the mortgage or sells it at a discount to an institutional mortgage lender such as Traders Home Plan Realty Limited or United Dominions Investments Limited.

Second mortgages are also helpful in cases where a borrower wishes to purchase a home that already has a first mortgage which is too low in amount to finance the purchase but has an attractive low rate. Since the rate on the existing first mortgage is attractive, the borrower may prefer to negotiate a higher rate second mortgage rather than a new first mortgage. If, for example, a home has a 6 1/4 percent first mortgage and current interest rates on new first mortgages were 10 percent, it would be worthwhile for the borrower to take a second mortgage with

an interest rate of 12 1/2 percent. Then the weighted average interest rate paid by the borrower on a combined first and second mortgage would conceivably be less than the interest rate which would apply if a new first mortgage was obtained. The overall monthly payment could be higher under a dual mortgage scheme than under a high ratio first mortgage because the amortization period on a second mortgage is normally shorter than on a first. This type of second mortgage origination activity is declining as the number of available lower rate 25 year NHA mortgages decreases and five year term mortgages become more common. A variant of this approach is the *wraparound loan* in which the lender assumes the old first mortgage and makes the borrower a new loan for a larger amount while advancing the difference between the total mortgage required and the outstanding balance on the old first mortgage. For example, if a borrower has a $10,000 first mortgage at eight percent and needs $30,000, the lender may assume the first and create another loan of $30,000 at 11 percent, advancing $20,000 to the borrower. The result is an effective yield of 12 percent or more for the lender on his $20,000 loan.

At one time, financial institutions subject to the investment limitations of the Canadian and British Insurance Companies Act were not permitted to make high ratio conventional mortgages (i.e., those in which the loan amount exceeded 66 2/3 and later 75 percent of appraised value). Consequently, if a borrower went to a financial institution, such as a trust company, and wanted to borrow 90 percent of the value of a property which he intended to purchase, and where an NHA loan was not appropriate, the trust company would put up 75 percent of the value itself and have the additional 15 percent of the value provided by some other investor. A trust company, such as Royal Trust, would charge its normal mortgage lending rate for the 75 percent of value first mortgage and another institution such as Niagara Realty Limited would charge a premium rate for the 15 percent of value second mortgage.[1] The borrower, unaware that there are two suppliers of funds, would make monthly payments to the institution that was servicing the mortgage. The overall rate of interest paid by the borrower could be about one-quarter percent over the normal prime rate of the trust company for conventional mortgages. In addition, the borrower may have had to pay a fee of one percent for raising the funds. This practice of "blending" a first and second mortgage was largely discontinued when trust companies and other financial institutions were allowed to make privately insured high ratio mortgage loans.

SUPPLIERS OF SECOND MORTGAGE FUNDS

The two major sources of second mortgage funds are private investors, including vendors, and financial institutions. Private investors make their funds available for the second mortgage market through accountants, lawyers or mortgage brokers. A mortgage broker would normally have a list of private investors willing to put varying amounts of funds into second mortgages and other loans.

1. Another example of this type of arrangement would be Northern Life Insurance Company taking a first mortgage and Central Covenants taking a second.

A second major source of second mortgage funds is the institutional sector. Affiliates of finance companies and acceptance companies, such as AVCO Realty, Niagara Realty, Canadian Acceptance Realty and Commercial Credit Corporation, are active in this market. Niagara Realty, for example, had nine branches across Canada that specialized in mortgage loans in 1973. These financial institutions pay mortgage brokers or real estate agents a *finders fee* for bringing second mortgages to them. The fee paid varies, but one firm suggested a flat $50 for the first $1,000 of the loan amount and one percent of the loan amount thereafter. Real estate agents provide the bulk of single family mortgage leads to institutional lenders.

TERM AND AMORTIZATION PERIOD

A second mortgage can have any term and amortization period acceptable to both borrower and lender. If the loan is originated by a financial institution, a five year term and 10 to 20 year amortization period are most commonly used although one major firm offers a seven year term and a seven year amortization period. Prepayment is usually allowed at any time with the payment of a three month interest bonus. When the lender has paid all origination costs other than legal fees, he may make the loan closed (i.e., non-repayable) for the first year in order to cover these costs.[2]

A vendor take back second mortgage is normally drawn up to permit prepayment at any time without notice or bonus. Since financial institutions purchase such loans at a discount, they are satisfied to have the loan prepaid without notice or bonus. Some uninformed vendors arrange mortgages with such unusual terms (such as a very low rate or a very long-term) that they are unable to sell them in the market except at a large discount.

YIELD

The yield on a second mortgage, like any other source of financing, depends on market conditions. During the pre-1969 period when there was a high demand for second mortgages, the yield on second mortgages was as high as five percent over the prime first mortgage rate. As more major insitutions began to give high ratio loans, this spread dropped to 2 1/2 percent. In the tight money period of 1974, the spread increased to 3 1/2 – 5 percent.

The interest rates charged vary from one institution to another. This enables a good mortgage broker to perform a useful function for clients by seeking out lower cost financing. The differences in rates are partly related to whether the lender or borrower pays the legal fee, appraisal fee or other investigating costs (the borrower usually pays) and partly due to differences in the cost of funds to lenders.

2. Some firms allow repayment but only at the expense of a severe penalty. One firm allows prepayment only if the borrower pays the interest which would have been paid for the balance of the year plus a three month interest bonus.

RISKS TO THE LENDER

Legal title to a mortgaged property is held by the first mortgagee. The claim of the second mortgagee is against the mortgagor and his equity of redemption. When the first mortgagee is allowed to complete a foreclosure action, all claim against the security by the second mortgagee is lost. If, however, the property is seized and sold by the first mortgagee or the courts, the second mortgagee is entitled to collect his loan amount from the proceeds of the sale after payment of expenses and the first mortgage loan. When only the second mortgage is in default, the second mortgagee may force sale of or foreclosure on the equity of redemption.[3]

As a result of the foregoing legal aspects of mortgages, if the property seems to have sufficient value, the second mortgagee when faced with default will often bring the first mortgage up to date and commence action against the mortgagor. Since foreclosure takes a long time, forced sale of the property is frequently employed.

A second mortgage is generally felt to have a higher risk than a first mortgage due to the fact that a second mortgage is a junior claim and because, in some cases, persons applying for second mortgages are not as good credit risks. Delinquency rates are higher than those for first mortgages.

Protection against defaults takes place in a number of ways. The primary protection that the lender has, however, is the inflated value of the property itself which has been steadily rising over the past few years. Thus, if the borrower defaults on mortgage payments, he can be forced into selling the property and paying his debts with little or no loss to the mortgagee. The loan to value ratio allowed varies from one financial institution to another. In response to rapidly rising house prices, many major lenders have decreased their maximum total loan to value ratio from 90 percent to 80-85 percent. When a borrower wishes to raise in excess of this maximum, finance companies will often make a consumer loan for the balance.

3. For a readable discussion of mortgage law, see J.E. Smyth and D.A. Soberman, *The Law and Business Administration in Canada*, Toronto: Prentice Hall, 1968.

Chapter 7

Real Estate Financing

The objective in this chapter is to provide a brief overview of the real estate development industry. Some of the problems of developing and financing serviced land and financing residential construction will be examined as well.

THE REAL ESTATE DEVELOPMENT INDUSTRY

The Canadian real estate development industry is made up of firms which vary substantially in size and in the nature of their activities. Nonetheless, it is useful to distinguish between four major types of activities in this industry: speculation, land development, construction and real estate investment.

A *real estate speculator* may be defined as an individual or firm who purchases and resells land or buildings for capital gains but does not improve the property. Little is known about speculators but it is widely felt that speculation has contributed to the increase in housing prices and has harmed the image of the entire real estate industry.[1] Moves have been made by industry associations and provincial governments to block speculators' activities.

In early 1974, when house prices rose at a rapid pace, the Ontario Mortgage Brokers Association voted to have their members ban loans to speculative purchasers of housing. Home builders also made speculation in housing more difficult primarily by tightening up their credit checking procedures. Perhaps the most dramatic step to curb speculation was taken by the Ontario Government when it implemented The Land Speculation Tax Act which became law effective April 9, 1974. The Act initially applied a 50 percent tax on profits realized from the sale of certain unimproved real estate. In subsequent months, there were several amendments and new regulations, one of which decreased the tax to 20 percent of the profits. This amendment was passed because the Federal government did not allow the Ontario land speculation tax as an income tax deduction. Thus, the rate was reduced so that no taxpayer would pay more than 50 1/2 percent under combined capital gains and land speculation tax rates. Taxed as an income transaction, the maximum combined tax rate for an individual could be

1. Not all people are against land speculation. For a discussion which asserts that high housing prices are not caused by land speculation see D. Baxter, "Land Speculation Doesn't Hurt House Prices-Professor," *CREA Reporter*, February 1975.

as high as 81 percent. It has been asserted that the tax successfully curbed the increase in land prices in Ontario. The proof of this assertion is clouded, however, by the downturns in the Canadian economy and particularly by a shortgage of mortgage funds and high interest rates in the period following the implementation of the tax. Although it is clear that there are speculative elements to any real estate development, our subsequent discussion in this chapter will be restricted to the non-speculative aspects of the business.

The function of the *land developer* is to acquire land, change it in some way to make it more suitable for building and, ideally, to bring it to its most economic use. Its most "economic" use could be in the commercial, industrial, residential or recreational areas. In the following discussion, we concentrate on land developed for residential purposes. This usually involves a feasibility study, followed by the submission and approval of a draft plan and the installation of services. For a firm in the land development business, it is sound strategy to accumulate raw land in advance of immediate needs to enable an orderly program of development. Many of Canada's public and private real estate development firms have been aggressively accumulating land for future development. As of early 1974, some of the larger land holdings of developers were Campeau Corporation (7,500 acres), S.B. McLaughlin Associates (6,000 acres), Bramalea Consolidated Developments Ltd. (5,000 acres), Great Northern Capital Corp. (9,000 acres), Western Realty Projects Ltd. (9,000 acres) and Carma Developers Ltd. (9,600 acres).[2]

In May 1973, the Urban Development Institute released a study indicating that in one particular zone in Southern Ontario, 40 of its members owned about 40,000 acres which represented between 85 percent and 90 percent of the developable land.[3] Of this total, about half was held by foreign controlled firms, primarily British.

The fact that large developers have established sizeable land banks has led to a continuing debate over the merits of private versus public land banking. The Federal government, in 1973, proposed that the three levels of government purchase large tracts of land that could be quickly developed to increase the supply and stabilize the price of serviced land. Substantial sums were set aside by CMHC for this purpose.[4] The Ontario Housing Corporation has carried out land banking activities for some years. In 1975, the Ontario Government established the Ontario Land Corporation (OLC) to finance the assembly of land which would be turned over to the special project corporations created by the government for the purpose of managing its development. There are opponents to public land banking. For example, a study conducted for the Urban Development

2. See McLeod, Young, Weir and Company, *Monthly Market Review*, March 1974.

3. See "Legislative Committee Hears Ontario Debate on Foreign Control of Land," *Canadian Building*, September 1973.

4. See "Ottawa Plans Massive Entry in Land Deals," *The Globe and Mail*, Toronto, October 19, 1973.

Institute concluded that public land banking would not result in lower land or housing costs unless direct subsidies were used.[5]

A third activity in the real estate development industry is the construction of buildings. ***Builders*** may develop their own serviced land or may purchase serviced land from developers. There are a large number of builders, varying from the individual who builds one or two homes a year all the way to the large corporation, such as Wimpey Construction, which builds hundreds of homes a year. The builder may construct homes under pre-arranged contracts with buyers or may put up homes "on speculation", offering them for sale as construction progresses.

The final activity in the real estate development field is the purchase of real estate as part of an income earning portfolio. This activity is carried on by individuals, small groups, financial institutions and corporations created for that purpose. In 1974, for example, Campeau Corporation had $273 million or over 64 percent of its assets invested in rental properties and rentals accounted for about 49 percent of total revenues.

Thus far, we have made a distinction between developers, builders and real estate investors. To some extent, there are firms which engage in only one of these specialized activities; however, the trend is for larger firms to engage in all three. For example, Consolidated Building Corporation has a land development division, a residential construction division and a revenue producing property division.

The diversification and growth in the size of real estate development firms has interesting mortgage market implications. A developer who develops land, constructs buildings and has a portfolio of revenue generating properties has outside income that can be applied to the debt service on a new project to help get it off the ground. This means that the large developer is a better risk and is in a better bargaining position with major lenders than was the case in the past. It also enables some developers to provide their own interim financing and, in some cases, to go directly to the capital markets for funds.

THE CREATION OF SERVICED LAND

The procedures which a developer must follow before raw land is suitable for the construction of residential housing is a subject of much controversey and some misunderstanding. Thus, it is useful at this point to give an overview of these procedures. The planning of residential developments is a provincial responsibility and is handled in a variety of ways across Canada. For illustrative purposes, we have chosen to discuss the procedures in Ontario. Although these procedures are similar throughout the province of Ontario, they may differ from one municipality to another.

5. S.W. Hamilton, *Public Land Banking - Real or Illusionary Benefits*, Toronto: Urban Development Institute of Ontario, January 1974.

Under the Ontario Planning Act, the Minister of Treasury, Economics, and Intergovernmental Affairs has the authority to create planning areas. The municipal council in each planning area appoints a *planning board*. This board prepares an *official plan* which must have the approval of the municipal council and the Minister of Housing for Ontario. The official plan contains general policy statements regarding land use, the types of services anticipated and priorities. In addition to creating an official plan, the planning board is normally responsible for *zoning*, a more specific regulation of land use.

A developer who is interested in a property makes an inquiry of the planning director of the municipality in which he would like to build. The purpose of this inquiry is to determine the official plan designation of the land and the essential services such as roads, walkways, street lighting, power supply and sewers, which will be required. He also must ascertain whether his proposed development can be accommodated within existing zoning by-laws. This could result in the developer suggesting changes in the official plan and zoning. At this stage, no commitment is made between the municipality and the developer since the discussion is informal and tentative. However, if the municipal planning and engineering departments expect that the developer's proposals will be acceptable to the various agencies involved, the developer is encouraged to formulate a *draft plan*.

At this point the applicant may own the land or may simply have an option to purchase. If he has an option, it will have cost him one to ten percent of the purchase price. Thus, assuming the land is valued at $1 million, the option would be worth $10,000 to $100,000. This purchase option could be renewable but if it is not renewable and not exercised, the developer stands to lose the option price.

If he is convinced of the feasibility of the project, the developer prepares a draft plan and sends several copies to the Ministry of Housing. This draft plan contains detailed information on the development as well as any proposed amendments to the official plan. Since the developer must consult with planners, have surveys completed, search titles and do preliminary engineering work, preparation of this draft plan may take six to eight months or more.

When the draft plan is received by the Ministry, it sends as many as 25 copies to municipal departments and other relevant bodies such as the traffic controller, assessor, director of education, transit commission, gas company, fire department and telephone company. At this point the developer enters into detailed formal discussions with local officials to settle such matters as school sites, open space, density of development and availability of public services.

The Ministry studies written recommendations from all concerned parties and, after settling any differences, recommends acceptance or rejection of the draft plan. The draft plan is normally approved with a number of conditions attached. One condition is often that the plan will not be accepted unless, if necessary, the appropriate local zoning by-laws are passed. The draft plan approval stage may take six months or more. When the Ministry receives written assurance from the municipality that the conditions have been met or will be met, a *final plan of*

sub-division is approved. This plan is then registered and development work begins. Installation of services may take about six months for a 200 lot subdivision.

Since the official plan and zoning by-laws play an important role in subdivision development at the municipal level, they warrant expanded discussion. As mentioned earlier, municipalities have an official plan which describes the anticipated land use and timing of development in very general terms. When a developer wishes to develop an area, he must ensure that his plan corresponds to both the land use and timing of development as noted above. The developer may, however, apply to have the official plan changed, a move that requires the approval of both the municipal council and the Ministry of Housing.

Municipal governments use zoning by-laws to exert control over the use of specific land areas. When a property has not yet been developed, it is normally zoned rural or farmland regardless of the designated end use in the official plan. As a result, the developer who wishes to erect buildings, such as single family houses, must request that the specific area be re-zoned. This re-zoning process can be time consuming as the municipality often uses zoning approval as a lever to influence a preferred type of development.

When the application for re-zoning is acceptable to municipal council, the new by-law is passed and all property owners within 400 feet of the re-zoned property are notified of the change. If, after 14 days, there are no objections the by-law is sent to the Ontario Municipal Board (OMB) for approval. The OMB sends the by-law to the Ministry of Housing for technical evaluation. If approved by the Housing Ministry, the OMB sends its approval back to the municipal council. When an objection to the by-law is filed by a property owner within 14 days, the objector and council attempt to work out a compromise. If the objection is overcome, the amended by-law is sent to the OMB as before. If the objection is not satisfied, the municipal council may withdraw the by-law or send it to the OMB along with the objection. Since an objection has been received, the OMB sets up a public meeting for the purpose of open discussion. The public meeting may be attended by representatives of the municipality, the developer and the public. Since the city has proposed the by-law, it will tend to defend the by-law at these hearings unless new information has arisen. It may take as long as six months from the time the municipality submits the by-law to the Ontario Municipal Board until the Board reaches a final decision.

The Ontario Municipal Board is a quasi-judicial body appointed by the provincial government and administratively it reports to the Attorney General. The Board handles a variety of appeals. For example, if council refuses or fails to act on a developer's zoning request within 30 days, he can appeal to the OMB. He may also appeal if the municipal government has failed to act on his proposed changes in the official plan or if he disagrees with the conditions that the Housing Ministry attaches to acceptance of the draft plan.

PROBLEMS IN PROVIDING SERVICED LAND

The availability and cost of serviced land in Canada is related to a number of factors, some of which will be discussed here. Before a developer begins working on a draft plan, he must assemble the land through either direct purchase or by taking out options to purchase. In some cases, assembly is held up by small landowners who refuse to sell or hold out for a higher price. In other cases, speculators find out about the assembly and push prices up. One developer, for example, began land assembly by paying $1,500 per acre but had to stop buying when the price rose to over $7,500 per acre.[6]

Another common complaint by developers is that the time and uncertainty associated with obtaining subdivision approvals increases the ultimate cost of housing.[7] The cost is increased directly if the developer has to allocate excessive time and resources to ensure approval. It is also increased if the developer has a substantial financial investment in the project, a return on which must be obtained from the selling price of the serviced lots. To the extent that the entire process is ambiguous and the outcome uncertain, a developer must earn a higher return on his capital as compared to lower risk alternatives. The time required for approval appears to be related to the growing need for good planning and the increasing complexity of coordinating such diverse activities as education, transportation, recreation and protection of the environment at both the municipal and provincial levels. This problem is compounded by the fact that citizen groups can quite easily disrupt and delay the planning process by opposing developments.

The availability of municipal financing is another problem faced by the developer. Although the developer must provide all services, including the sewer and water lines, the trunk sewer lines and sewage disposal plant are the responsibility of the municipality. Small municipalities may have difficulty financing these facilities, a task that is made more difficult if existing residents oppose the use of taxes to finance expansion.[8] In order to raise adequate revenues, some municipalities only approve expensive housing which generates high property taxes but is more difficult for the developer to sell. Most municipalities levy an impost on each lot developed which is to be used to cover the expenses associated with such developments. The result is a direct increase in the price of land.[9] CMHC and the Ontario Government have long standing programs of assistance to municipalities which have eased the problem of providing sewage disposal facilities.

6. "Land Costs: A Side of the Story the Public Never Hears – Told by a Developer," *Canadian Building*, March 1973.

7. For an expansion of the argument see, for example "Red Tape Felt Adding to Carrying Cost of Land," *The Globe and Mail*, Toronto, March 8, 1974, "The Bureaucratic Conspiracy", *Canadian Building*, February 1973 and "The Developer's Dilemma – The Tide is Turning Against the "Reformers' in the Battle for Progress," *Canadian Building*, May 1974.

8. See "Lack of Sewage Plants Critical Factor in Providing House Lots," *The Globe and Mail*, Toronto, May 17, 1974.

9. For an example of a conflict between developers and a municipality over a lot levy see "Builders, Developers Launch Ad Campaign Against Lot Levy in Oshawa," *The Globe and Mail*, Toronto, December 6, 1974.

There is a feeling by some of the public that land developers withhold large blocks of land from development in order to push up the price. Although developers deny these claims, the Federal government has introduced tax legislation in order to speed development. Under the present Income Tax Act, developers may charge the carrying costs of all land assemblies against other taxable current income. Proposed revision of the Act would force the developer to capitalize these carrying costs and to write them off for tax purposes only at the time the specific property was sold. This revision is, of course, being opposed by developers who claim that developments are often delayed because of the difficulty of obtaining draft plan approval and that such a tax change would only push property prices up further.

INTERIM FINANCING

When a home, apartment building or commercial property is completed, it is normally financed by a mortgage of long or intermediate term. Usually, these mortgage loans are made in the form of progress advances as the structure is built. At other times, particularly if the market for the product is weak or the builder is not financially strong, the lender will supply the funds upon completion of the project. Other variations on this theme are possible, however, such as beginning advances when the home is sold whether it is completed or not, or beginning advances when an apartment building is up and substantially rented.

Interim financing is closely related to long-term mortgage financing. In this context, it refers to the short-term financing which is necessary to accumulate land, service land or construct a building. Interim financing is followed by longer term permanent financing. According to a study by McLeod, Young, and Weir and Company in January 1973, interim residential and non-residential construction lending in 1971 amounted to in excess of $1.7 billion while another $400 million was spent on land development.[10] These two demands for funds were estimated to represent over 30 percent of the gross annual mortgage requirements of the private sector. Given the size of this sector and its close relationship to the mortgage market, it is useful to discuss some of the types of interim financing available and the firms that supply these funds.

A variety of interim lending arrangements are available including development loans, construction loans, and gap financing.[11] A *development mortgage loan* refers to a relatively short-term loan of up to three years for the purpose of acquiring and servicing unimproved land. This short-term loan is normally repaid when the land is sold and is made without a prior take out commitment. The development loan funds are usually provided at a cost which is a floating rate based upon the prime bank lending rate. There may also be a *stand-by fee*

10. See McLeod, Young, Weir and Company, *The Canadian Mortgage Mortgage Market*, Toronto, June 12, 1973.

11. For a discussion of these and other types of loans, see the prospectuses put out by Heitman Canadian Realty Investors (Wood Gundy, March 16, 1973) and TD Realty Investments (McLeod, Young, Weir and Company, September 20, 1972).

for the provision of these funds. In some cases, the lender may seek a higher return through equity participation.

Construction mortgage loans are short-term loans of less than three years duration for the purpose of the development of property. As a rule, advances are made against these mortgage loans based upon stages of construction. The rate charged is a floating rate based on prime. A stand-by fee is charged for any unused balances. The rate charged on construction loans is higher by one percent if no take out commitment exists on the property.

Gap financing refers to short-term loans that are made to builders to finance the difference between the amount advanced by the long-term lender and the requirements of the builder. The term of such financing may be up to three years and the rate of interest is higher than some other forms of financing because of the junior position of the lender.

For a fee, some lenders are willing to make a *stand-by commitment* to a builder. Under this agreement, the lender agrees to provide a certain amount of money at a stated rate at a stated time in the future. This arrangement assists the builder in obtaining interim and long-term financing from other sources. Frequently, the institution making the stand-by commitment does not really expect to have to provide the long term funds committed.

Chartered banks have historically been the largest suppliers of interim financing. By far, the majority of these loans have been of the gap financing type; banks make loans against progress draws rather than take out commitments. The most commonly quoted rate for such interim financing by banks is the prime corporate lending rate plus a premium of up to two percent. This type of lending carries certain risks such as an incomplete building or mechanics' liens. As soon as there is any trouble in a construction job, the supplier of permanent financing freezes the permitted draws, leaving the interim lender to protect himself. It is interesting to note that most of the interim financing by banks in Canada is against progress draws, while the United States banks normally make advances against a take out commitment. One reason for this difference in development is that until 1967 Canadian chartered banks could not legally make a mortgage loan and as a result preferred the smaller shorter term commitment. In the United States, banks commonly make interim loans at prime plus a one percent commission for arranging the financing and a 20 percent compensating balance. This represents a greater relative interest rate in the United States than in Canada.

In the American environment, where there were relatively high interim financing interest rates, *Real Estate Investment Trusts (REIT's)* were attracted into the interim financing business. A similar pattern has been followed in Canada. Within the last few years, four REIT's have been formed in Canada. Of these, two – TD Realty Investments and Heitman Canadian Realty Investors – have indicated a desire to provide interim financing to the construction industry. Both

of these institutions will supply construction loans, development loans, gap financing and stand-by commitments. There is, however, some question as to whether REIT's will be as successful in Canada as they were in the United States given the smaller available yield.[12]

Some of the trust companies have indicated a willingness to undertake interim financing. The most outstanding example of an involvement in interim financing by a trust company is the subsidiary formed by the Royal Trust Company.[13] The Royal Trust Company has combined with the Continental Illinois Corporation to form Builders Financial Limited which through its subsidiaries, Builders Capital Limited and Western Builders Capital Limited, is designed to provide higher risk interim financing on new construction. This company charges a rate of 1 1/2 to 2 1/2 percent above prime plus a placement fee of from 1 to 1 1/2 percent of the face amount of the loan. Builders Financial appears to be heavily oriented toward the commercial, industrial and shopping centre business. There is some interim financing of high rise apartment dwellings as well. The funds employed by Builders Financial come from primarily three sources: bank lines of credit, commercial paper and Royal Trust. According to the Globe and Mail article, Builders Financial is "more interested in making secure "quality' loans at a lower rate than speculative loans at higher rates".

In late 1973, MM Builders Funds was set up by Marine Midland Bank – Western of Buffalo and Merban Capital Corporation of Toronto to finance developments.[14] Other firms which are active in this area include United Dominions Limited, Benjamin Pape Associates, Heller Natofin and the City Savings and Trust Company.

Some of the smaller higher risk builders have found it necessary to go to mortgage brokers in an attempt to find interim financing. These brokers may refer the builder to groups of investors or one of the firms previously mentioned. On smaller deals, the mortgage broker may ask a group of individuals to provide amounts such as $50,000 each. For this investment, the investors would probably receive a return of about 15 percent or 1 1/4 percent per month. Usually the duration of such interim financing is from six to seven months. In return for putting the deal together, the broker would receive about one percent of the amount borrowed.

Gap financing is relatively more common than construction mortgage loans, partly because lenders want to get their money working as quickly as possible.

12. At the time of writing, American REIT's, specializing in construction and development loans, were under pressure due to delayed projects, bankruptcy of some major developers and a shortage of credit. As indicated in Chapter 16, Canadian REIT's have not had problems of this type.

13. See "Royal Trust Affiliate Hopes for a Portfolio of $150 Million," *The Globe and Mail*, Toronto, December 20, 1972.

14. "Firm Set Up for Financing of Development," *The Globe and Mail*, Toronto, September 15, 1973.

They are, therefore, willing to commit long-term funds and loan them out early as advances. This is particularly true if the advances are insured. Even insured advances, however, are not without risk since in the event of foreclosure, insurance does not cover all attendant legal costs or loss of interest if the foreclosure is protracted. Interim financing in excess of $15 million per project seems to be done primarily by companies outside Canada, particularly by large U.S. life insurance companies. This role of providing large sums of money for interim financing purposes may be an area where real estate investment trusts can have some impact.

FINANCING THE BUILDER

The builder may arrange to have long-term financing made available at the end of the project (*completion loan*) or during the course of construction (*progress loan*). In either case, the builder will have to use his own equity capital and interim financing as explained earlier. The progress loan method is the most common especially in the building of single family homes. Our discussion in this section will focus primarily on the short- and long-term financial problems facing a small builder who arranges for progress loans, a situation common in the construction industry.

The small builder normally relies on the larger developers for a supply of serviced lots. In the past, they were advised as much as one year to 18 months in advance that serviced lots were going to be made available, however, in a tight market for serviced land, this lead time falls to as short as six months. With the increasing vertical integration of the large real estate development companies, this problem may become chronic for the small builder, making his planning a more difficult task. At one time, when there was a surplus of serviced land, the developer would make a verbal commitment to the builder to supply a certain number of lots. This agreement was quite flexible as it allowed both the developer and the builder to back out of the arrangement with no deposit paid. With changing conditions, it is now more common for the builder to make a deposit of approximately 10 percent of the price of the land. This deposit is accompanied by a written promise to pay the balance, at the builder's discretion, within a certain time. This arrangement locks the builder into a building program which brings his homes to the market at a particular time in the future. In addition, when the builder is participating in a major development, he is constrained by the developer as to the general types of houses he can build including the minimum square footage of living space. Within this framework, the builder chooses the type of product he feels will sell the best and which will fit into the development.

The builder, who is assured of an available supply of serviced land, then approaches both interim lenders and long-term lenders for financial assistance. He commonly goes to more than one institution for his financing. This is done to ensure more flexibility in negotiating and a reasonably guaranteed supply of funds. Financial institutions encourage this practice for several reasons. One of the reasons given is that institutions are uncertain as to the level of future commitments they can meet. Thus, they prefer that borrowers have an alternative

source of money should funds become tight. In addition, the branches of some institutions are limited in the number of loans that they can make to any given builder. One branch of a very small trust company had a limit of five loans for any one builder except in special circumstances. In another case, there was a limit of 30 loans to a given builder and only if a certain proportion of those were conventional mortgages. There is also a possibility that financial institutions see themselves as spreading risk if they do not take all of the mortgages of a single builder. A final reason is perhaps that financial institutions, by meeting part of the needs of a large number of builders rather than all of the needs of a few builders, are able to maintain contact with many customers in the market. Some banks have suggested to the builders with whom they deal that they establish a continuing relationship with some other financial institution, preferably a non-bank. Large life insurance companies, however, are less inclined to worry about spreading funds than trust companies and banks. The smaller, less established builders may hire mortgage brokers to shop for financing on their behalf and for assistance in presenting their case to potential lenders. While larger builders may use mortgage brokers, they frequently have their own mortgage specialist on staff.

Financial institutions may allocate funds to builders as much as a year in advance and make a definite commitment as to the rate and amount three months in advance. The builder seldom starts construction without firm commitments of serviced land and mortgage funds. A commitment fee of from one-quarter to one percent of the loan amount is charged by the lender. This fee is refundable if the builder draws the first advance within a certain time period, such as 90 days. The amount of the commitment fee varies depending upon market conditions. If money is tight or if commitments are made far in advance, the fee tends to be higher and, in some cases, non-refundable. When funds are available and the builder has a long-standing relationship with the lending institution, there may be no fee at all. In some cases, there are no penalties for reasonable delays in the draw down of funds caused by such factors as weather conditions. The practice of *block funding* has arisen in recent years particularly with banks. The bank commits a specific amount of funds to the builder to be drawn down over the year as new projects are started. The interest rate is fixed when specific commitments are issued against the block funds. The builder pays a non-refundable fee to the bank for such an arrangement.

If the builder should change his mind and walk away from the deal, he would lose his commitment fee. A builder would not normally walk away from a lending arrangement unless he had an unexpected construction problem or interest rates fell severely and he felt that he could get a much better interest rate elsewhere. It should be stressed, however, that both the borrower and the lender are trying to establish a reasonably permanent relationship. When the borrower and lender interact frequently, they begin to handle their affairs much more efficiently. Where a new relationship has to be established each time a loan is made, this is not always possible. In addition, a lender becomes more flexible with a regular borrower.

Before the project is initiated the financial institution normally agrees to advance funds to the builder in accordance with a pre-arranged schedule. For example,

equal amounts may be paid out at the insulation stage, the "finished plaster" stage, and the completion stage. Another procedure is to advance 50 percent of the funds when the roof is on, 25 percent of the funds at the finished dry wall stage, and 10 percent on completion. The lender is careful to always retain sufficient funds to complete the project in case something should happen to the builder. There is normally a 15 percent holdback until the property is fully completed (except for personal items) and the title is transferred to an approved purchaser who has assumed the mortgage.[15] Some lenders are more generous in interpreting when the holdback can be paid than others.

Small builders often run into difficulty because of the manner in which payments are advanced and the need for a holdback. If, for example, a small builder intends to build on a single lot that cost him $10,000, he would give the developer an advance of five percent or $500 as a down payment on the lot.[16] The builder then provides his own interim financing, for as long as his money holds out, to construct the dwelling on the lot. At the "roof on stage", he has the lending institution inspect his progress in order to receive his first advance. However, before he can receive his first advance he must have clear title to the land. In order to obtain clear title to the land, the builder must pay the subdivider his remaining $9,500. The lending institution then makes its first advance of $12,000 to the small builder. At this point, the roof may already be on the house but the builder has little funds to pay to the various trades for working on the home. As a result, the builder may have to rely heavily on interim financing which can be expensive. In addition, he might sometimes rely on the sub-trades and suppliers to provide him with extended credit to carry him through this period. The willingness and ability of the sub-trades to provide extended credit depends on the size of the sub-trade and how much demand there is for their services. Trade credit may extend anywhere from one week to 60 days while payments to labor are essentially cash.

To avoid financial difficulty, the small builder must have working capital of approximately $5,000 per home under construction. For example, a $40,000 house will eventually have a 90 percent mortgage on which the lender is willing to advance 85 percent of the funds until a buyer is found. It is reasonable to assume that the gross profit to be made by the builder on an individual house is about 10 percent. In this case, the builder receives, at completion of the house, total progress payments of $30,600 and has expenses of approximately $36,000, leaving a short fall of $5,400. If for some reason a lien is placed on the project or if

15. A 15 percent holdback is required by the Mechanics Lien Act. The Act prescribes a holdback until 37 days after the construction is substantially completed. A lender will have lower priority then lienholders if the funds advanced exceed the work done at the time of the advance.

16. The down payment may be from $500 – $2,000 with a one year mortgage at the going interest rate (e.g., 11 percent for the balance). If the small builder does not know whether he wants to buy the lot, he can take out an option for two months for approximately $100. Most agreements between developer and builder specify that the land must be built on instead of being held for speculative purposes.

the builder has difficulty selling the house for 60 or 90 days after completion, he will have to pay off all of the sub-trades employing some form of interim financing. Thus, one can see that timing of the advances and sale of the property is important to the builder and any delay can be financially costly to him.

At one time, a substantial amount of building was done on a *pre-sold basis* where the purchaser was quoted a firm price for a finished product which the seller then proceeded to build. As the demand for housing accelerated the larger builders built houses on speculation expecting them to be sold at a profit. As the rate of inflation grew and building supplies became less available, builders were still able to build on speculation because demand remained high. However, in 1974 and 1975, with prices still rising but demand for housing falling, builders became less aggressive in their speculative building and began to fall back on the pre-sold technique.

As indicated earlier, the builder can have the lender make an advance commitment as to the amount of funds and the rate which will be paid. If interest rates rise after the commitment is made, the lender will honor the commitment; thus giving the builder a rate which is below the market rate when selling his house. If interest rates decline substantially after the commitment is made, but before the property is sold, the builder is left with an uncompetitive interest rate on the mortgage on his property.

One strategy the builder could adopt is to hold the house until interest rates rise again; however, the costs of carrying the mortgage and any interim financing would soon become prohibitive. Instead, the builder is likely to either lower the price of the house or arrange to have the interest rate lowered. Most lenders will lower the interest rate if the builder pays a fee to the lender. This process is called *discounting* or *buying down* a mortgage. A fee of one percent of the loan amount is equivalent to a reduction in rate of one-quarter of one percent on a five year term mortgage. During 1973 when interest rates on houses rose sharply to above 10 percent and then fell, several builders were caught with high mortgage interest rates on their houses. They were able to survive only with the assistance of the lending institutions who were willing to cut back the interest rate to the existing market rates. Of course, those builders that had not established an ongoing relationship with one of the major financial institutions had more difficulty in arranging their financial affairs than did those who had cultivated good relationships. Some lenders limit the amount that a builder is allowed to buy down the mortgage as they want to maintain a reasonable match between asset and liability interest rates.

Builders may also use the mortgage interest rate as a selling device. They have been known to borrow from lenders at a discount in order to get a low rate. For example, a builder arranges for a nine percent mortgage when going rates are 9 1/4 percent, and receives less than the full amount of the mortgage when the project is completed. The cost associated with this lower-than-market interest rate on the mortgage is simply built into the house price. Some builders have the

lending institution keep their commitment fee as a type of discount on the mortgage. CMHC permits this practice on their insured mortgages as long as they are informed of the details of the transaction.

As we have seen, builders rely heavily on mortgage funds in order to finance their activities. The higher the loan to value ratio provided to the builder, the better off he is on two accounts. First, he requires less working capital in order to construct the building and second, a high ratio mortgage makes it easier for the builder to ultimately sell the property to a consumer.

Builders have a particularly difficult problem during periods of inflation. A builder may have a loan approved for 95 percent of the appraised value of a property based upon plans for a house at a point in time. If the cost of building materials for that property subsequently rise, it means that the house will have to sell for substantially more than its original appraised value if the builder is to make any profit. Some appraisers, however, are unwilling to place a value on a property which is higher than the most recent price at which a number of sales have taken place. When a subdivision is relatively new and prices are rising rapidly, it is unlikely that there will be any recent sales at this new high price. As a result, the builder cannot obtain a 95 percent mortgage based upon his selling price and has to settle for substantially less. This means that the home buyer has to make a larger down payment and it is somewhat more difficult for the builder to sell the property. In addition, many of the homes constructed by builders are sold before they are finished and the final cost established.

PROBLEMS WITH APARTMENT BUILDING

The larger developers construct apartment buildings for resale or for retention as a revenue producing property. In late 1974 and 1975, apartment construction slowed drastically. This slowdown has been attributed to high interest rates, rising construction and maintenance costs and the general fear within the industry of rent controls which could put a limit on revenues. As a result, the selling price of apartments in some areas in 1974 fell below replacement cost. Small developers who tied their equity up in apartments which they hoped to resell had to stay out of the development business until a sale could be arranged. In some cases, apartment builders shifted into the construction of high rise condominiums or conversion of apartments into condominiums in order to return money from an unprofitable rental property. These conversions are increasingly meeting government obstacles.

Chapter 8

The Contact Between Borrower and Lender

There are a variety of ways in which contact is established between a borrower and lender. This chapter will examine the role of real estate salesmen and mortgage brokers in the mortgage origination process.

REAL ESTATE AGENTS

Functions of Real Estate Agents

A *real estate agent* or *realtor*[1] assists both sellers and purchasers of property. His primary function is to bring the two parties together but he may act as an advisor to either or both participants.[2] The agent advises the seller on how best to sell the property, shows the property to interested buyers and provides advice on the procedures of property transactions. He helps the purchaser to narrow down the potential properties to those which are most appropriate to his needs and can provide information on such features as taxes, utility costs and neighborhood characteristics. Real estate agents must complete courses and qualify for a license from a provincial body, such as the Ministry of Consumer and Commercial Relations in Ontario.

Some property owners prefer to sell their property without the assistance of a real estate agent. This is particularly true when the demand for properties quite clearly exceeds the supply. In theory, if one employs a real estate agent, he should be able to get a better price for his house because the real estate agent advises him of the true market value of his house. The agent is also able to contact more potential buyers, especially if a multiple listing service is used.

The minimum rate charged by a real estate agent is generally set by the real estate board in his area of operation. For example, in Ontario the London and

1. The designation *realtor* is a registered certification mark associated with membership in the Canadian Real Estate Association.

2. From a legal point of view, the real estate agent acts solely for the vendor except in rare circumstances. This is particularly true in commercial real estate where advice to the purchaser is minimal. In selling houses, the agent has a slightly different role and tends to provide advice to both parties even though he is legally the agent for only one party. This is spelled out clearly in the Real Estate and Business Brokers Act of Ontario.

St. Thomas Real Estate Board has set a rate for its members of five percent of the selling price for an exclusively listed property and 5 1/2 percent for a multiple listing.[3] When the selling agent is a different person from the listing agent, the seller receives 60 percent of the fee and the listing agent receives 40 percent. If the salesman is working for a firm which has provided him with administrative services and physical facilities, the firm provides him with a portion of the fee. The proportion of commission remitted by the firm is a matter of negotiation between the company and the individual salesman. It may vary between firms and within the same firm. Typically the salesman receives 50 percent or more of the commission.

In mid 1975, amendments to the federal Combines Investigation Act were enacted by Parliament. These amendments would bring service industries, such as real estate, under the Combines Act and could make the commission rate setting of local boards illegal. In anticipation of this legislation, several real estate boards have freed members to set their own rates.

In order to be a member of a local real estate board, the salesman must pay a fee. For example, the London and St. Thomas Real Estate Board charges an initiation fee of $250, annual dues of $27 plus $20 per month for each salesman. Some salesmen pay the monthly fee themselves, while in other cases the firms pay the fees on their behalf.

Role in Finding Mortgage Funds

Real estate agents often have a significant influence on where the home buyer obtains a mortgage. The salesman frequently acts as an independent entrepreneur who has long established relationships with a number of mortgage lenders. By maintaining these relationships, the agent is able to ascertain which lenders are providing mortgage funds, what their rates are and the type of mortgage loans they prefer. A good salesman will obtain quotes as to rate and appraised value from two or more lending sources before advising his client.

Since the primary objective of the salesman is to quickly consumate a sale, the speed of processing and availability of funds are important. The real estate agent is also influenced by the *finders fee* that some financial institutions pay for mortgage contacts. Trust companies, life insurance companies, and chartered banks have all paid finders fees at one time or another. A common finders fee is one percent of the principal amount of the mortgage, but other plans are possible such as one-half of one percent to a maximum of $250. Some trust companies pay a finders fee only to their own real estate agents. The presence or absence of a finders fee depends on whether lending institutions have a shortage of available funds and, in some cases, on the long established policies of the lender.

Many trust companies have their own real estate division and are therefore close to the real estate business. Some of the large trust companies who have offices

3. The reader should note that real estate practices and fee structures vary from one area to another.

across Canada are in a position to handle some of the personnel transfer problems of large corporations.[4] They can also refer to their salesmen any real estate activities associated with their estate, trust and agency accounts. In spite of these ties, the trust company real estate salesmen often look to other firms for their mortgage funds, attracted by finders fees, long standing relationships and better terms.

Real estate agents are even more active in advising borrowers where they can secure second mortgage funds. In fact, many financial institutions that make second mortgage loans rely solely on real estate salesmen and mortgage brokers to acquire this type of loan. The fee paid to a real estate agent for originating a second mortgage may vary from $50 all the way up to five percent of the amount borrowed.

Purchasers of homes may ask real estate agents to advise them whether to apply for an NHA insured mortgage or a high ratio mortgage insured by a private mortgage insurance company. In virtually all cases, however, the lender makes this decision. For most real estate salesmen, speed and the amount of money that can be obtained are the critical factors. Consequently, salesmen tend to prefer the private mortgage insurance scheme.

MORTGAGE BROKERS

The Brokerage Function

Just as the real estate agent brings together the buyer and seller of real estate, the mortgage broker brings together the borrower and lender associated with a mortgage. He may also provide technical expertise which facilitates the transaction. Differences between mortgage brokerage firms center on the type of clientele they service, the volume of business done and the nature of the technical expertise provided.

Small and Large Brokers

The small mortgage broker receives requests for financing from home buyers, small businessmen and builders. These requests may be for interim financing or first or second mortgage funds. He would not normally receive requests from large developers, builders or individuals who were prime first mortgage credit risks. The small broker may have contact with a number of potential investors including small private investors. The rate they require is usually related to the prime borrowing rate. For example, at a time when the prime bank rate was 11 1/2 percent, many mortgage brokers were attempting to place second mortgages at 16 percent. Most mortgage brokers have no funds of their own available and act merely as a contact between borrowers and lending institutions.

4. This does not only apply to trust companies since some of the real estate firms are joined in Canada-wide organizations which perform the same function.

Perhaps the most valuable function performed by the small mortgage broker is that he tries to be constantly aware of the lending status of the various financial institutions. He acquires a knowledge of those firms who are willing to accept a 25 year term rather than a five year term, the types of loans each firm avoids and the current interest rate being charged. In effect, the broker is able to do the "shopping around" for a borrower who may not have his own established source of financing.

The large mortgage broker differs from the small broker in that he obtains funds from financial institutions on behalf of the builders and developers. He typically does not deal with individuals as borrowers or lenders. Some mortgage brokers specialize in interim and second mortgage financing while others obtain long-term financing. Although the industrial and commercial business of mortgage brokers is growing, the business remains primarily mortgages on new multiple family dwellings. Due to the low insurance limit on privately insured mortgages, most of the large multiple family mortgages placed in the past were either NHA insured or conventional. However, this is changing as private insurance company maximum loan limits become more competitive.

A developer or builder has many concerns in the course of putting a project together. He may purchase land, have it zoned, install services, manage the construction and sell or rent the final product. Except during periods of tight money, a builder can usually locate his own source of financing. However, because the broker is continually in the market, he may be able to locate a better source of funds. He may also advise the borrower on the type of project most easily financed, the best sources of financing and current market conditions. Since the size of apartment buildings may range from 10 to 1,000 unit projects, it is often necessary to use several lenders at once. The mortgage broker helps to put this type of deal together.

With current competitive conditions, mortgage brokers must either advertise their services or call on builders and developers to indicate the services they have available. A certain amount of business is repeat or referral business.

Underwriting Activity

Underwriting, within a mortgage context, refers to the analysis of the investment merits of a mortgage loan and organizing the presentation to be made to the ultimate lenders.[5] As lenders, such as pension funds, become increasingly sophisticated, they require that documentation, much like a prospectus, accompany loan applications. The result has been an increase in the need for so-called underwriters who maintain a staff for this purpose. Some of the larger firms active in this market are Canmort Consultants Limited, A.E. LePage Limited, Morguard Trust

5. *Underwriting* of stocks and bonds is normally the term reserved for the purchase of securities by an investment dealer for resale to the public. In the mortgage business, the mortgage underwriter assists in the preparation of a proposed loan request but neither makes the loan himself nor guarantees that a certain amount of funds will be raised.

Company, Murray and Company, a subsidiary of Prudential Assurance Company of England, Edgecombe Investment Services Limited, a subsidiary of North American Life Assurance Company, and Seel Enterprises Limited. In western Canada, Coronado Mortgage Corporation and Cumberland Mortgage Corporation are active in this area.

The mortgage broker or underwriter normally begins by assisting the builder in structuring the project and in obtaining the required financing. He anticipates the requirements of the lender in terms of security and documentation so that a presentation can be made which will enable the lender to quickly determine whether he is interested in the project. Because a knowledgeable broker knows his lenders' preferences, he usually submits only projects which are likely to be accepted. This assists lenders by reducing their screening workload.

The mortgage lending community is fairly close and lenders have substantial knowledge of each others activities. When a loan is turned down by several lenders, other lenders find out about it and the loan becomes tainted because it has been "*shopped*". Although the loan might originally have been rejected for reasons other than underwriting and the project itself could be improved, the "taint" tends to remain. By ensuring that the project is properly structured initially and submitted to an appropriate lender, the possibility of ending up with a project which is difficult to finance can be greatly reduced.

A well prepared mortgage investment proposal contains information on the property and the proposed terms of the loan. There may be a discussion of the builder or developer group indicating several of the projects in which they had participated in the past, and establishing their competence to carry out the present project. The costs of the project are outlined in detail along with anticipated completion and draw dates. Another function of the underwriter is to assist in putting together proforma financial statements for the property. These projections include proposed revenue from the project, estimated operating costs, and the cash flow available to service the loan. The nature of the real estate and the market in which it is located must also be evaluated.

Mortgage Loan Correspondents

Some investors, such as life insurance companies, do not have mortgage origination facilities in certain geographical areas. Under such conditions, they acquire the services of a *mortgage correspondent*. A mortgage loan correspondent originates, processes and administers mortgage loans on a continuing basis for a number of clients. For example, Cumberland Mortgage Corporation represents ten institutions, primarily life insurance companies, who need representation in western Canada.[6] Although all mortgage brokers attempt to place mortgages with

6. As of October 1974, these firms were Monarch Life Assurance Company of Canada, The Prudential Assurance Co. Ltd., Massachusetts Mutual Life Insurance Co., Mutual Life Insurance Company of New York, Excelsior Life Insurance Co., Central Covenants Ltd., Canadian Premier Life Insurance Co., National Life Insurance Co. (Mortpelier, Vermont), Lutheran Life Insurance Society of Canada and Occidental Life Insurance Company of Canada.

investors, only the larger firms act as designated correspondents for several lenders. Trust companies are active in this area as well.

Investment Dealers

Investment dealers have clients who are already investing in stocks and bonds and who are beginning to consider mortgages. Since clients of investment dealers often do not have the in-house capability to evaluate mortgages, investment dealers have to either hire people to perform this function or team up with the underwriter to provide this service. An example of the latter relationship is between Wood Gundy and Canmort Consultants.[7] Wood Gundy, Dominion Securities-Harris & Partners, Midland Doherty and Burns Brothers and Denton have all actively sold mortgages in recent years. The participation of some investment dealers in the mortgage market seems to be directly related to particular members of their staff, and if these persons leave the firm, the extent of its activity in the market changes.

Brokerage Fees

When a broker brings a buyer and seller together, he is paid what is called a referral or finders fee. As discussed earlier, real estate agents are paid a fee for second mortgages and may or may not receive a fee for originating first mortgages. There is a suggested maximum fee schedule put out by the Ontario Mortgage Brokers Association for all loans under $40,000 originated by their members. This fee schedule for outside Metropolitan Toronto is:[8]

Mortgage Placed with Financial Institution	2% of the gross amount of the loan plus $150 basic fee.
First Mortgage Placed With Private Lender	4% of the gross amount of the loan plus $150 basic fee.
Second Mortgage Placed With Private Lender	5% of the gross amount of the loan plus $150 basic fee.

These fees may include payment for activities other than bringing the borrower and lender together. Discussions with brokers indicated that the fees are often lower than the suggested maximum. For example, the fee on a first mortgage may be one percent and on a second mortgage two percent. The larger brokers are involved in much larger projects and may have to perform more lengthly underwriting activities. They would charge a fee on a sliding scale such as:

1% of the first $50,000
1/2% of the next $50,000
1/4% of the next $900,000
1/8% over $1 million

7. Wood Gundy subsequently purchased control of Canmort.

8. Ontario Mortgage Brokers Association, *Ontario Mortgage Brokers Association Manual*, Toronto.

This, of course, is a crude estimate. The amount of the fee varies, depending on the difficulty of the task and market conditions. Fees are generally higher if interim financing is arranged and higher still if there is a significant amount of underwriting activity. The fee is paid separately on commitment or out of mortgage draws rather than added to the loan.

The fee structure in the mortgage brokerage business is interesting in that the fee is paid sometimes by the borrower and sometimes by the lender. For example, one major broker indicated that in the period 1969 to 1971, when there was a shortage of funds, borrowers tended to pay most of the fee. In 1972 and 1973, however, most of the fees were paid by the lenders. When the builder pays the fee, he simply adds it to the cost of the project. If the lender has to pay, the resulting decrease in his yield may be charged against either the cost of not having an in-house mortgage underwriting department or the cost of obtaining the investment. This additional cost is approximately one-eighth of one percent of the yield of a 30 year loan. Even in periods of tight money, some life insurance companies pay the origination fee in order to ensure a supply of mortgage offerings in times of easy money.

Mortgage Broker Designation

In order to be a mortgage broker, an individual must be licensed by the province in which he operates. In Ontario, the licensing body is the Ministry of Consumer and Commercial Relations. He must generally conduct his affairs in accordance with the provincial Mortgage Brokers Act which provides for an examination before a license can be conferred. The Ontario Mortgage Brokers Association (OMBA) offers courses to its members to assist in the education of aspiring brokers. Under the OMBA, a professional body called the Society of Accredited Mortgage Brokers has been set up.[9] In order to qualify for membership, a candidate must have a minimum of four years experience and have completed the primary and secondary courses offered by the OMBA.

9. See "Ontario Course for Mortgage Brokers May Be a Trend Setter," *Canadian Building*, October 1973.

Chapter 9

Topics in Mortgage Administration

The previous chapters were concerned with the needs of the borrower and how contact was established between borrowers and lenders. This chapter, however, will deal with mortgage administration, primarily that of single family mortgages, as seen through the eyes of the lending institution.[1] Specifically, it will examine the origination of mortgages and their subsequent servicing followed by a description of activities in specific types of financial institutions.

EVALUATING THE MORTGAGE APPLICATION

When a firm receives a request for a single family mortgage loan, a number of steps are normally taken. These include a preliminary interview, an appraisal of the property and a credit rating check. If the loan is acceptable, funds are committed to the borrower subject to a satisfactory title search. This section examines each of these steps in mortgage origination.

The Interview[2]

The potential borrower normally fills out a mortgage application in advance of the interview. If he is purchasing a new house, he may be assisted by the builder who already has a mortgage on the house. If he is purchasing an existing house, he may be assisted by a real estate salesman. During the interview the lender will discuss the employment status and income level of the borrower and his spouse. He will want to know the borrower's present financial position (assets and liabilities), including the cash equity available to complete purchase of the property. A preliminary discussion of the amount of loan that will be available, the interest rate, the amortization period and the term takes place at this point.

The interview is intended to aid the lender in evaluating whether the borrower is a responsible person. He may also try to determine whether the borrower wants

1. A discussion concerning the evaluation of mortgages on multiple family, commercial and industrial property is contained in Chapter 7.

2. Interviews are not necessarily mandatory with all institutional lenders but they are helpful in assisting the lender in evaluating the application and permitting the borrower to obtain information. At least one trust company requires a personal interview only for borderline cases.

to purchase the house as a long-term investment (i.e., as a home) or if he is simply buying the house for quick resale – a less desirable purpose.

Debt Service

The lender wants to grant a loan which will be repaid in accordance with the terms of the mortgage contract. If the loan goes into default, he will rely on the value of the mortgaged property or mortgage insurance to recover his investment.

A guideline used to evaluate the ability of the borrower to repay is called the *Gross Debt Service (GDS) Ratio.* The GDS ratio is the ratio of the total annual principal, interest and property tax payments to the gross income of the borrower. On loans insured by CMHC or by private mortgage insurance companies, the insurers provide guidelines on how high this ratio is allowed to be. CMHC recommends that this ratio should not exceed 30 percent. However, an institution can recommend a borrower with a higher ratio if the lender is satisfied that the client will be able to repay.[3] Private mortgage insurance companies are somewhat more specific. For example, the Mortgage Insurance Company of Canada (MICC) considers a GDS ratio of 27-30 percent acceptable but asks that any payment on a second mortgage or land rental payment be included in the GDS ratio calculation.

In special cases, when all financial factors are favorable, insurers are willing to accept a GDS ratio of over 30 percent. An example of this is where the applicant is expected to increase his earnings substantially in the near future or has a high net worth. The guidelines provided by mortgage insurers do not seem to be strong constraints on lenders; most financial institutions demand equally rigorous adherence to ratios for their non-insured loans. In fact, one large trust company recently decreased its GDS ratio on all loans from 30 percent to 27 percent, partly in an attempt to allocate scarce funds to the more credit worthy borrowers.

Lending institutions have some latitude in the definition of gross annual income. For example, on a CMHC insured loan both the husband's and wife's total incomes are included in computing the ratio, while some financial institutions permit the inclusion of only part of the wife's income.

An increasing number of financial institutions compute a *Total Debt Service (TDS) Ratio.* The TDS ratio is the sum of all principal, interest, tax and other instalment debt payments as a percentage of gross income. MICC suggests a TDS ratio limit of 37-40 percent while institutional lenders have a variety of other guidelines. When a borrower has no other debts, MICC is prepared to give favorable consideration to borrowers with a GDS ratio of 32-33 percent.

3. In 1974, 50 percent of approvals under the NHA had GDS ratios below 27 percent.

The Credit Check

Lenders typically verify all of the information provided in the mortgage application form. For example, the employment status and income may be confirmed by direct contact with the employer. The lender may obtain a credit report through a credit bureau or from other financial institutions. A written credit report from a credit bureau may cost about $7.00 whereas a verbal credit report may cost only $1.50. Although CMHC does not require a written credit report with its loan applications, private insurers generally like to have this included. Personal and financial references are usually contacted. Some of the personal characteristics of borrowers mentioned as being undesirable are frequent job changes, generally poor character, excessive drinking, fraud, and marital discord.[4]

Property Appraisal

Following the interview and prior to final consideration of the application, arrangements are made by the lender to inspect and appraise the property. The lender must satisfy himself that the property measures up to the desired location, construction and other standards, keeping in mind the possibility of having to take over and sell the property to recover his investment in the event of default. Also, the appraised value is of prime importance in establishing that the loan amount comes within the statutory loan to value ratio limits. Financial institutions frequently reduce the loan to value ratio below the maximum permitted if funds are limited.

While many factors enter into an appraisal, only some of them will be mentioned here.[5] The primary objective of the appraisal from the lender's point of view is to estimate the potential selling price of a property. On new construction, the appraiser usually begins with the market value of the lot and adds the cost of landscaping, paving and building the structure. Appraisers regularly contact builders to determine current construction and land costs. For existing housing, the appraiser looks at depreciated replacement cost and the price at which comparable properties are selling. In the case of commercial properties, the appraiser looks at replacement cost, market prices and the capitalized value of the future income to be generated. The appraisal of a house for mortgage purposes usually consists of a brief one page opinion. Of course, a more detailed analysis is done for larger properties.

4. Several provinces have recently passed legislation which restricts the types of information that lenders are able to obtain. For example, The Consumer Reporting Act (Bill 101), passed in Ontario in July 1974, set standards for recency, accuracy and corroboration in consumer credit information given out by consumer reporting agencies. When adverse action is taken on a loan request as a result of a credit report, the consumer must be informed of the fact and given the right to obtain and question the data in the hands of the credit reporting agency. This legislation will likely decrease the use of "personal" information as opposed to financial information.

5. For a discussion of real estate appraisal in Canada, see The Appraisal Institute of Canada, *Real Estate Appraising in Canada,* Winnipeg, 1973.

Discussions with a number of lenders uncovered several features that tended to decrease the mortgageability of single family residential properties. Some of these features included:

- located outside city limits,
- small lot,
- building does not meet the standards of the National Building Code,
- property is on leasehold land (except under the HOME plan),
- property is outside institution's lending area,
- mortgaged property is not owner occupied,
- property is old and not modernized,
- property is part of a strip development,
- no municipal water supply or sewers,
- subject to noise or other pollution,
- one or two bedroom house,
- the building is structurally unsound,
- neighborhood in transitional stage,
- no basement or only a partial basement,
- certain types of artificial siding, and
- shared driveway.

Some of the features that lenders felt tended to make a house more mortgageable included:

- on a cul de sac or court,
- new house in a reasonable location,
- no heavy traffic on street,
- on a treed lot,
- finished recreation room, and
- all services readily available.

Lenders usually employ their own mortgage appraisers (as in the case of most trust and life companies) or hire an independent appraiser (as is the case of most banks). The appraisal fee, payable by the borrower, ranges from $50 to over $100 with some variance between new and existing properties. In the case of new construction, the lender conducts a series of building inspections during the construction stage in addition to the initial appraisal made from the plans and specifications and site location. The borrower is charged a fee for these inspections. When the loan is made by or insured by CMHC, a fee of $35 is paid to cover the cost of appraisal and inspection of the property.

In the event of default, the lender relies on the resale value of the property mortgaged to protect himself against loss. Thus, it was considered prudent practice in the past to ensure that the borrower had insurance on the property at least equal to the amount of the mortgage. With the increase in land prices, a substantial amount of the mortgage loan has been for the land on which the building stands. As a result, insurance on the building equal to the amount of the mortgage is frequently excessive and it is now prohibited in some jurisdictions to require insurance in excess of the house value. Many major lenders have a blanket policy for the insurance of all dwellings on which they have mortgages. The fee for this blanket insurance policy is paid by the lender.

The Title Search

Before a loan can be made, the lender requires that a title search be made to ensure that the borrower has, or can obtain, clear title to the property. The title search takes place after loan approval, but before any funds are disbursed. Some financial institutions require that their lawyers carry out the title search, while others will allow the purchaser's lawyer to perform this service.

The borrower pays the lawyer a fee of approximately 1 1/4 percent of the mortgage amount plus disbursements for drawing up and registering the contract, searching the title and performing other related duties.[6] This fee structure is set up by provincial and county law associations. The legal fees associated with real estate transactions have been attacked as excessive by some politicians.[7]

The lawyer searches the title and certifies the validity of the title to the mortgagee. He further certifies that the registered mortgage is a valid first charge on the property on which it is registered. The title is typically not insured by the lawyer. As a result of his investigation, the lawyer may point out infringements of the title and in so doing transfers the responsibility for accepting the title to the financial institution. If an encroachment on a property is discovered, a *quit-claim deed* may be arranged wherein all rights or interest in a property are given up by the borrower or a third party owning the adjoining property. Another option is to acquire an easement such as a right-of-way on the property.

Approval of the Application

If the borrower meets the minimum GDS and TDS ratio requirements and has a satisfactory credit rating and if the title to the property is clear and the loan to value ratio is acceptable, final approval of the mortgage can be expected. The interest rate will be the prime mortgage rate charged by the lender or slightly above if it is a higher risk loan. Although 25 years is a common amortization period, this may be shortened if the property is older or if there are elements of unusual risk present. Where the loan is conventional, approval can be expected

6. This fee depends on the amount of the loan and the legal technicalities involved.

7. See "Basford Declares Exhorbitant Legal Fees Boost House Prices," *Toronto Star*, June 3, 1973.

quite promptly; if the loan is to be insured, however, a delay may occur until approval of the private or public insurer is obtained.[8] When an offer to purchase accompanies the mortgage loan application, it normally contains a time limit, such as 15 days, within which financing must be arranged. Thus, there is some pressure to approve the loan within two weeks.

Mortgage Insurance Approval

An approved lender sends information such as the valuation of the property and the completed loan application form to the mortgage insurance company (CMHC or private). Based on these data, if the loan is satisfactory, the insurance company fills out a *commitment to insure* (called *undertaking to insure* by CMHC) and sends it to the lender. This commitment is normally valid for a period of three months for loans on existing properties and one year on builders' loans. Upon receipt of the commitment and disbursement of the funds, the lender sends the relevant data to the insurance company which, in turn, sends back a *certificate of insurance.* Insurance coverage actually begins at the time the funds are disbursed. At least one private mortgage insurance company employs a *master policy.* In this case, the lender only sends information on disbursements to the insurance company monthly, at which time all certificates of insurance are issued for that month's transactions. On builder loans, the mortgage insurance company issues individual commitments covering several properties. When the homes are finally sold by the builder to the new homeowner, the lender proceeds to apply for a certificate of insurance as above.

Point Rating of Applicants

In order to provide some uniformity in evaluating mortgage loan applications, a number of financial institutions employ a numerical scoring system.[9] The applicant is scored on a number of dimensions such as gross debt service ratio, type of employment, length of employment, age, assets, and future prospects. The total score over all dimensions is compared to a minimum score. If the score exceeds the minimum, the application is accepted, if not, it is rejected. This point scoring system is, however, used only as a guide and not as a substitute for judgment. It is interesting to note that one bank, The Royal Bank of Canada, provides potential mortgage investors with the point rating of the mortgagor for each mortgage sold. This, of course, is only useful if the original mortgagor still owns the home.

SERVICING THE MORTGAGE

The Nature of Servicing

After the mortgage funds have been disbursed, the account must be administered.

8. For NHA and privately insured loans, approval of the insurer is a prerequisite. Checking of the title is not done before insurance approval although it is done before any funds are advanced.

9. For a more detailed discussion of the use of scoring systems for credit evaluation see J.C. Van Horne, *Financial Management and Policy*, 3rd ed., Toronto: Prentice Hall, 1974, pp. 486-490.

The administration of a mortgage account is referred to as *servicing* and involves collecting monthly payments, ensuring that there is adequate insurance protection on the property, paying taxes, following up on delinquencies and handling defaults. The servicing activities of many financial institutions take place at the branch level, although several firms have a head office computer instalation on which mortgage accounts and certain types of information are recorded and from which payment overdue notices are sent.

The mortgage contract usually requires the borrower to repay the mortgage in monthly instalments. Some lenders also require that the monthly payment include an allowance for property taxes which is paid by the lender. Other lenders require borrowers to pay their own taxes and then check regularly to ensure that taxes are current. A billing system is not normally used. Instead, a variety of possible payment methods, such as deduction from a trust or bank account, predated or pre-authorized cheques or cash, are used.

The Economics of Servicing

A financial institution which services mortgages for its own account may sell blocks of mortgages to other investors, retaining the servicing activity in return for a contracted administration fee. In order to facilitate the execution of documents, such as a *discharge of mortgage*,[10] the mortgage usually remains in the name of the servicing institution even though all risks are borne by the investor. Many institutions may originate and service conventional mortgages but mortgages insured by private insurance companies or CMHC can only be serviced by firms designated by them as *approved lenders*.[11] These approved lenders include most of the major financial intermediaries in Canada.[12]

In return for its servicing efforts, the servicer receives a payment which is stated as a percentage of the remaining principal amount of the mortgage. The going rate for single family mortgages is three-eighths of one percent and for multiple family dwellings, such as apartment blocks, it is one-eighth of one percent. One should not, however, have the impression that these rates are inflexible. The rates on apartment buildings are particularly subject to negotiation. For example, one firm indicated that if the size of the loan was greater than $1 million, the servicing fee was only one-tenth of one percent and for large projects the fee was negotiable.

Although the profitability of mortgage servicing is the subject of debate, most financial institutions strongly desire to retain the servicing on any mortgages that

10. A *discharge of mortgage* is a legal document filed in a land registry office which formally discharges the borrower from his mortgage loan obligation.

11. Restrictions on the corporate powers of life insurance companies under the Canadian and British Insurance Companies Act preclude these firms from operating a "servicing for fee" business except through an approved subsidiary. Edgecombe Investment Services Ltd., a subsidiary of North American Life, is an example.

12. *Approved lenders* are discussed in more detail in Chapter 5.

they originate.[13] Some firms want to retain the servicing because they consider it profitable; other firms, and especially banks, prefer to retain the servicing because they feel that the regular contact between the mortgagor and the bank increases the possibility of doing other kinds of business with the customer. Because of the difficulty of devising an accurate costing system and the many intangibles involved, many institutions do not have a precise idea of the costs of servicing mortgages. One lender indicated that he felt that servicing individual loans of under $10,000 was not profitable. Another lender indicated that one would need to service at least $200 to $300 million in mortgages before a mortgage department would be economical. Still another institution suggested that if the mortgage servicing activity was done manually, the three-eighths percent charge on single family mortgages would be unlikely to cover costs. Yet, if an institution was fully automated, once the set up costs were covered, the cost to service could be as low as one-eighth of one percent rather than the three-eighths percent charged.

Some investors and most pension funds are not approved lenders and, consequently, do not do the servicing themselves. They do, however, frequently request that the servicing associated with the mortgage be turned over to their nominee in return for services rendered.[14] Although most financial institutions prefer to retain servicing, it is considered by some to be a saleable commodity. For example, an originating institution could sell the mortgages to a pension fund and the related servicing to a trust company. There has been some speculation about selling mortgages on a prepaid servicing basis, but at the present time there seems to be no activity in that area. Past attempts have led to complications, such as the prepayment of principal on which servicing has been paid and accounting for the amortization of servicing fees.

When an originator sells a block of mortgages to an investor, it charges a periodic servicing fee and may charge a premium for the mortgages as well. The premium is intended to cover the costs of origination, such as interviews, printing, head office processing, and any finder's fees paid. The amount of the premium could be one percent of the principal which over a 20 year amortization period is approximately equal to one-eighth of one percent off the yield to the investor.[15] The origination premium depends on competitive conditions and the servicing fee charged. Some institutions have been known to reduce their origination fees in order to obtain the servicing associated with the mortgages. For example, a pension fund indicated that in one case it signed an agreement with a

13. See for example "How much is Servicing Worth," *The Mortgage Banker*, October 1969.

14. Many firms use a system of correspondents to originate mortgages in geographical areas where they are not represented. This permits the lender to benefit from a local firm that is knowledgeable, well equipped and closer to the local market. Metropolitan Life, Dominion Life, North American Life and Northern Life are examples of firms that use correspondents in some areas of Canada.

15. The computation of mortgage yields is complicated by the fact that one normally assumes that the loans are repaid in full at half the remaining term. This is discussed in greater detail in Chapter 17.

trust company for a servicing fee of one-twentieth of one percent plus a cash payment to the trust company which would cover the origination costs.

Delinquency and Default Procedures

A borrower is expected to pay his mortgage payments promptly. If, however, the borrower becomes delinquent, the financial institution normally goes through a series of steps reminding him that his payment is due. The first reminder may go out when the account is 10-20 days in arrears with a stronger reminder following in a week to 10 days. This may be followed by a telephone call from the branch manager or a letter indicating that legal steps will be taken unless the payment is received. If delinquency persists, the lender may instruct its solicitor to send a letter indicating that legal procedures have been initiated to settle the claim. At this stage, the borrower may recognize the seriousness of the problem and may want to make some kind of arrangement with the lender. A number of arrangements are possible, but two of the more common arrangements are where the borrower sells the property and pays off the mortgage or the lender agrees to have the client remedy the default over a period of several months at which time he will again become current. Normally, when an account is in arrears, financial institutions prefer not to refinance the entire amount outstanding. It should be stressed that financial institutions prefer to avoid legal action. If the borrower has had a good payment record or where arrears arise in cases of ill health or unemployment, the lender typically makes a major effort to accommodate the borrower.

If the borrower cannot pay or refuses to pay, the financial institution has a number of options.[16] One option is to file a *writ of foreclosure* which, if the court grants a final order, enables the mortgagee to obtain title and dispose of the property as it sees fit. The law provides every opportunity for the mortgagor to avoid foreclosure which tends to make this a lengthy process. In some provinces, another option allows the lender to initiate *power of sale proceedings* in which the financial institution can force the sale of the property, retaining the amount owing plus expenses and giving the remaining proceeds to the mortgagor. Although power of sale is a faster procedure, the onus is on the financial institution to sell at a reasonable price.

A third option is to take possession and collect all income from the property until the debt is satisfied at which time possession is returned to the mortgagor. In some provinces, the lender can sue the client on his personal covenant; however, the individual being sued is usually in financial difficulty and, consequently, this is not a very effective device.

16. The options available are related to provincial laws which are not uniform across Canada. For an elementary but readable discussion of the law of mortgages and some of the provincial variations see Smyth and Soberman, *The Law and Business Administration in Canada*, 2nd ed., Toronto: Prentice Hall, 1968.

Another option is to try to have the borrower voluntarily sign a quit claim deed, turning the property over to the lender without legal action. In this case, the lender would normally make some financial payment to the borrower.

It is interesting to note that if a mortgage has been sold, the risk of loss is borne by the investor but the servicer normally handles all delinquency and default activities as part of the normal servicing activity for no extra fee except for out-of-pocket costs. In some cases, the original mortgagee may guarantee to repurchase the mortgage from the investor if a default occurs. Of course, the investor must approve of any legal course of action.

The Economics of Delinquency and Default

An account is *delinquent* if the borrower is behind in his mortgage payments. A *default* occurs if the lender must undertake legal proceedings to collect the amount owing. In the event that an account is delinquent, the lender loses the opportunity to use his funds elsewhere due to late receipt of interest and principal repayments. He also faces increased servicing costs associated with making the account current. If an account goes into default, there may be a loss of interest or principal plus the cost of taxes and insurance and the cost of repairing and carrying the property until it is disposed of. There is also a selling fee if the property is sold by a realtor.

Most institutions have a low delinquency rate (approximately one percent of all accounts) and a negligible default rate. One of the reasons given for the low default rate is that there has been a strong demand for housing in recent years and prices have been steadily increasing. This means that should a borrower get into financial difficulty, he can always sell his house and pay off the mortgage. Thus, he avoids becoming a default statistic. In addition, when a mortgage goes into arrears, there may be a second mortgage on the property. In this case, the holder of the second mortgage will often clear the arrears on the first mortgage and exercise his remedies.

When mortgage insurance is taken out on a property, many of the out-of-pocket costs of default are covered but the time taken up by staff in the mortgage department is not repaid. In order to make an insurance claim, the lender must foreclose and take clear title plus vacant possession. This can take anywhere from six to 18 months depending on the provincial courts and the circumstances surrounding the action.

INSTITUTIONAL ROLES IN MORTGAGE ORIGINATION

This section outlines the mortgage origination activities of some of the major financial institutions; namely, banks, trust and loan companies and insurance companies. It covers the branch system, the types of mortgages the institutions prefer, their administrative procedures and the competitive environment. A more detailed discussion of the investment and portfolio policies of these firms is deferred until later in the book.

The Personal Sector

Although the following deals mainly with institutional mortgage originators, it is useful to mention the importance of private sources of mortgage funds in order to provide some perspective. Of the more than $8.6 billion in mortgages originated in Ontario in 1973, $1.0 billion or 12 percent were NHA mortgages;[17] of the remaining $7.6 billion, $2.2 billion or 29 percent were provided by the personal (i.e., non-incorporated) sector. The importance of the personal sector in mortgage lending is further revealed when one notes that funds for over 110,000 or 41 percent of all conventional mortgages registered in Ontario in 1973 were provided by this source. The operation of this sector and its impact on the housing and mortgage market merit careful study but are not covered in this book.

Chartered Banks

There are 10 chartered banks in Canada, with the five largest controlling over 90 percent of bank assets. All banks combined have over 6,200 branches through which they provide a wide variety of financial services to corporate and individual customers. It is at the branch level that banks are in direct competition with other institutions for the origination of mortgages.

In a number of Canada's chartered banks, branch managers request an annual allocation of funds for mortgage loans. The extent to which the desired funds are provided depends on a number of factors such as the general availability of funds and the past volume of lending at the branch. This allocation process can be influenced by the individual branch manager's attitude toward mortgage lending. The branch manager has many functions, varying from administering the branch to making personal loans to renting safety deposit boxes. If he is carrying out these functions satisfactorily, he may not have a great deal of interest in aggressively pursuing the mortgage business. Thus, many branches originate mortgages only occasionally, making it necessary for the manager to rely on an extensive procedures manual for assistance. Other managers are better informed and may recommend deviations from the relatively rigid rules which have been set down by head office. Still other branches have a full time mortgage manager. These branches tend to do a substantial amount of mortgage business and have greater autonomy.

Bank branches report on their activities and receive guidelines from district offices. The district manager keeps the branch manager informed of prevailing interest rates, approves all mortgages and allotments of funds to builders, and may approve the outside lawyer and appraisers used by the branch manager. In addition, the district manager will sometimes package bundles of mortgages for resale to institutional investors.

17. Ontario Ministry of Treasury, Economics and Intergovernmental Affairs, *Realty Mortgage Loans Registered in Ontario During 1973*, Toronto: Queen's Printer, February 21, 1975.

Once the mortgage has been granted and the payments begun, one of two things may happen, depending on the particular bank; the branch may retain the mortgage on its books or may pass the mortgage information on to the district office. The district office may credit the branch with a fee for initiating the mortgage and a servicing fee for handling the month-to-month administration. In some banks, the way in which this internal allocation of the profitability of mortgages is handled tends to influence the degree of interest a branch manager has in initiating mortgages. For example, if a branch originates a number of mortgages and these are in turn packaged and sold off to some ultimate investor with the branch receiving no future credit for the mortgages, the branch manager tends to be less enthusiastic about originating additional mortgages.

Bank mortgage lending activity has closely paralleled changing bank legislation. It was only in 1954 that banks were first permitted to make mortgage loans and these were restricted to NHA insured loans on new dwellings. This led banks, who were already providing interim financing, to emphasize loans to builders. NHA insured mortgages were relatively easy for the bank manager to originate because they were insured, and all documentation was provided by CMHC who also provided the expertise to conduct appraisals and inspections. The result has been a lingering preference on the part of some branch managers for the origination of CMHC insured loans. The 1967 revision of the Bank Act permitted banks to make loans on existing properties and uninsured loans; later, they were permitted to make high ratio privately insured loans. The result was a surge in loans for existing properties but this was tempered by the fact that banks had to train staff to carry out some of the functions formerly performed by CMHC. It is only in recent years that banks have begun making rental property loans on a large scale. This is partly because some banks have not yet developed the depth of expertise in this area possessed by competitors and also because banks prefer doing mortgage business with individuals.

The chartered banks originate sufficient mortgages to meet their own requirements and have the capacity to originate mortgages for resale. Since they are almost all national institutions, they are able to make a wide variety of mortgage loans over a broad geographical area. The Canadian Imperial Bank of Commerce has a slightly different arrangement; it employs its wholly owned subsidiary, Kinross Mortgage Corporation, to handle the approval of all bank mortgages. All servicing is carried out by the bank.

Trust Companies

There are over 60 trust companies in Canada with more than 600 branches. The five largest firms account for 60 percent of all company and guaranteed account assets. The mortgage origination activities of trust companies differ somewhat from those of banks due partly to their investment policies and partly to their branching strategy.

Most trust companies have three types of branches: savings, mortgage and full service. The savings branch is concerned with taking in deposits and selling financial services such as registered retirement savings plans, investment funds,

safety deposit boxes, travellers cheques and Canada Savings Bonds. Mortgage branches deal exclusively in mortgage loans. Full service branches make mortgage loans and sell financial services as well. The number of each of these types of branches varies from one firm to another but mortgage branches are uncommon. When a mortgage request is made at a savings branch, it is passed on to a mortgage or full service branch.

The mortgage operation in the branch of a trust company usually includes an inspection department and an administration department; the inspection department handles mortgage underwriting, interviews, credit checks and appraisals while the administration department looks after servicing and delinquencies. As opposed to banks, the full service branch of a trust company tends to have all of the in-house expertise necessary to originate mortgage applications.

Trust companies appear to have emphasized mortgages on existing residential properties more than banks have. This can probably be attributed to the fact that trust companies were never forbidden from making mortgages on existing properties, thus allowing them to establish a foothold in the business, and also to the fact that some trust companies have real estate departments or affiliated real estate companies, whereas banks do not. Perhaps because of their accumulated experience, trust companies originate more multiple family, commercial and industrial mortgages than banks. This tendency has been accentuated by the strong competition from banks in the single family home area.

Trust companies have a history of originating mortgages for their estate, trust and agency (ET&A) accounts although the importance of ET&A business varies from one firm to another. The result has been that trust companies have begun to originate mortgages for smaller financial institutions and major pension funds such as CNR and Ontario Hydro. Banks have, in recent years, become originators of mortgages for other investors as well.

Life Insurance Companies

At the end of 1973, there were 162 life insurance companies operating in Canada of which 82 were incorporated in Canada. These companies had an estimated 2,400 branches of which five percent or less were used for purposes of originating mortgages. Most of the remaining branches were used as sales offices. The five largest companies accounted for approximately 40 percent of the premium income. This business is somewhat less concentrated than the trust or banking business.

A typical life insurance company mortgage branch resembles a trust company mortgage branch, being divided into an inspection or origination department and an administration department. The administration function is increasingly being performed by regional and head offices. One different feature of life insurance company operations is that many of their branches rely more heavily on mortgage brokers to supply leads. The degree of lending authority of the branch manager varies from firm to firm. In one firm, the branch managers are not

allowed to make any final decisions and must rely on head office; in others, the managers have authority at least comparable to the managers of trust company branches.

At one time, insurance companies provided the bulk of mortgage funds in Canada. However, with changes in legislation and the rapid growth of trust companies, this role has become less pronounced. In the last four or five years, insurance companies have rapidly increased the proportion of multi-family, commercial and industrial versus single family mortgage origination. This change could be due to increased bank and trust company competition in the single family area or the more attractive loan terms available on multiple family, commercial, or industrial property. In particular, insurance companies are attracted to long-term investments to match the long-term nature of their liabilities. Most insurance companies are organized to originate large project or builder mortgages rather than mortgages on existing single family properties.

Competitive Postures

Life insurance companies are generally considered to have the greatest mortgage origination expertise. This expertise is most effectively utilized by the insurance companies through their origination of commercial and industrial mortgages. Trust companies rank behind insurance companies, but ahead of banks, in terms of expertise.[18] This is probably because any trust company branch that originates mortgages has mortgage specialists on hand, whereas almost all bank branches originate mortgages, thus leading to a variable performance depending on the branch manager's familiarity with mortgages. In order to overcome this problem, some banks have extensive manuals to assist the manager and, moreover, have established offices in certain areas that specialize in mortgages. In the past, banks were competitively most effective in originating NHA insured mortgages. This, however, is changing with the rapidly expanding role of banks in the mortgage market.

Trust companies are generally viewed as the institution that provides the fastest approvals. This is due to the higher dollar approval ceilings at the branch level and the in-house capacity to appraise the property and evaluate the application. Speed of approval is also related to the locality. Of course, this speed is more important in mortgages for existing single family properties than it is, for example, with builder's loans where more advance planning goes into the mortgage application. To the extent that banks can increase the dollar approval level at the branch or can effectively utilize regional mortgage offices they may become more competitive.

18. Although this is correct as a general statement, there are a few trust companies which have developed a great deal of expertise as a result of their mortgage banking operations and by acting as correspondents for American insurance companies. Montreal Trust, for example, represents the Metropolitan Life Insurance Company and Travelers Insurance Company, while Metropolitan Trust represents the New York Life Insurance Co., Mutual Life of New York, State Mutual of America and John Hancock.

One advantage that has been claimed for banks is their immediate access to credit information on their customers which gives them a competitive advantage in conducting investigations. Furthermore, since banks provide interim financing for builders, they have a greater opportunity to negotiate mortgage loans on new housing.

Most financial institutions have paid finder's fees at one time or another. Insurance companies seem to utilize mortgage brokers most frequently but the presence or absence of finder's fees depends on competitive conditions. Trust companies are probably the second most frequent users of finder's fees, paying them both to mortgage brokers and real estate agents. Most chartered banks, however, do not pay finders fees at all because their extensive branch network provides all of the mortgages required.

The interest rate on mortgage loans charged by financial institutions is based on the cost and availability of funds to the institution along with the yields on alternative investments such as net leases and bonds. All institutions revise their rates as underlying economic conditions change. With respect to single family house mortgages, there does not appear to be a substantial difference in the interest rate charged. One may, however, find deviations on the part of the smaller trust companies which, in attempting to gain a foothold in the business, may accept riskier mortgages at a somewhat higher rate. A wider diversity in rates is available with multiple family, commercial and industrial mortgages depending on the loan quality and how the loan fits into the investment objectives of the lender.

Another competitive difference between financial institutions is the terms offered on the mortgages. Trust companies seldom accept a mortgage with a term in excess of five years; this is true for single family, rental and commercial mortgages. Banks are also hesitant to accept a mortgage with a term longer than five years. Life insurance companies have varying strategies with respect to the term of mortgages on single family houses. Some life insurance companies, such as London Life and Equitable Life, are willing to lock themselves into long-term mortgages while others are beginning to prefer the five year term as a consequence of the steady increase in interest rates over the last few years. All life insurance companies are prepared to accept long-terms on corporate loans although there is some evidence that they are willing to accept some shorter terms (5-15 years). The willingness on the part of life insurance companies to take a long-term mortgage may give them a slight competitive advantage in the commercial and rental property areas as builders want the option of locking in their interest rates for a substantial period of time. Historically high rates have made builders increasingly ambivalent on this point.

Trust companies are permitted by law to operate real estate sales branches whereas banks and insurance companies are not. This is something of an advantage to trust companies who are able to become better informed about housing conditions and attract mortgages on existing single family residential dwellings. Life insurance companies have not expressed a great deal of interest in this kind

of business in recent years. Chartered banks have traditionally emphasized relationships with builders and, although they are now active in existing house loans, their large branch network has been able to attract adequate business. Consequently, neither insurance companies nor banks see themselves as severely inhibited by not being permitted in the real estate sales business.

Chapter 10

Central Mortgage and Housing Corporation and Ontario Housing Corporation Activities

The quantity and quality of available housing in Canada has been a concern of all levels of government for many years. The major vehicle employed by the Federal government to exert influence in this area is the Central Mortgage and Housing Corporation. In this chapter, the direct lending activities of this corporation will be reviewed. Some provinces have begun to exert a substantial influence on housing as well. Each province has some form of housing authority, a detailed discussion of which is not feasible here. Since the Ontario Housing Corporation is the largest of its type in Canada, its operations will be examined.

CENTRAL MORTGAGE AND HOUSING CORPORATION

The National Housing Act

The National Housing Acts (NHA) of 1938, 1944, and 1954, along with subsequent revisions, were passed in order to "promote the construction of new houses, the repair and modernization of existing houses, and the improvement of housing and living conditions".[1] In 1946, the Central Mortgage and Housing Corporation (CMHC), a federal crown corporation, was formed to administer government housing activities under the NHA. The NHA gives CMHC the power to engage in a number of activities including making guarantees, doing special studies, insuring mortgages made by approved lenders, and making direct loans. As of the end of 1974, CMHC had almost 3,200 employees administering an annual capital budget of over $1.4 billion, outstanding loans of over $6.75 billion and insured loans of over $11.9 billion.[2] This chapter examines the major financial activities of CMHC with the exception of the mortgage insurance program which is discussed in Chapter 5.

CMHC is authorized to make direct loans to individuals, corporations or government bodies and to take an ownership position in land or buildings. Table 10-1 indicates the major types of capital expenditures and loans made under the NHA

1. *National Housing Act*, R.S.C. 1970, c. N-10-1070

2. CMHC, *Annual Report*, 1974.

Public Funds Provided Under the National Housing Acts
($ millions)

Table 10-1

	Section 58 Home Owner-Ship and Rentals	Section 15 Low Income Rentals	Section 42 Land Acquisition and Assembly	Section 43 Public Housing	Section 47 Student Housing	Section 53 Sewage Treatment	Section 25 Urban Renewal Loans	Section 40 Federal-Provincial Housing and Land	Section 55 Land Acquisition and Direct Const.	Other Unclassifiable	Section 34.15 Assisted Home Ownership	Total
1957	191	—	—	—	—	—	—	*	—	61	—	252
1958	324	—	—	—	—	—	—	*	—	79	—	405
1959	309	—	—	—	—	—	—	*	—	71	—	380
1960	150	—	—	—	—	—	—	2	—	29	—	181
1961	238	26	—	—	10	—	—	2	—	60	—	335
1962	154	8	—	—	24	—	—	2	—	67	—	255
1963	281	20	—	—	24	—	—	2	—	59	—	386
1964	346	12	—	—	40	26	4	5	—	35	—	468
1965	386	14	—	36	32	27	5	5	—	81	—	586
1966	451	20	—	61	53	34	1	15	*	4	—	634
1967	513	31	—	114	57	31	9	34	*	18	—	808
1968	252	86	—	129	74	40	7	41	*	—	—	628
1969	163	177	8	171	56	50	15	37	*	—	—	677
1970	362	314	15	235	41	78	4	38	1	—	—	1,089
1971	203	311	11	277	37	114	15	42	*	—	—	1,009
1972	110	138	7	238	14	115	13	107	*	—	—	742
1973	38	155	162	200	4	154	1	75	4	7	133	933
1974	40	199	81	177	4	172	—	79	11	27	435	1,225

Note: * means less than $1 million

Source: CMHC, *Canadian Housing Statistics,* various issues.

since 1957. CMHC is also authorized to make grants or subsidize certain housing related activities. Table 10-2 shows the grants and subsidies paid out by CMHC in the last five years.

Grants, Contributions and Subsidies Under the National Housing Act, 1970-1974 ($ millions) **Table 10-2**

Section		1970	1971	1972	1973	1974
Part V	Housing Research	4.3	6.7	8.0	6.4	9.3
23, 24	Urban Renewal Grants	23.4	22.3	20.7	13.9	13.5
53	Sewage Treatment	6.9	14.3	23.1	37.8	25.7
40, 44	Public Housing	9.4	17.1	30.0	46.2	63.4
34.16	Assisted Home Ownership	—	—	—	0.7	5.0
27.2, 27.4	Neighbourhood Improvement	—	—	—	0.1	2.7
27.6	Rural & Native Housing	—	—	—	—	5.7
15.1	Non Profit Housing	—	—	—	—	6.4
	Other	—	2.0	—	5.8	12.3
	TOTAL	44.0	62.4	81.8	110.9	144.0

Source: CMHC, *Canadian Housing Statistics*, 1974.

Section 58 Lending

Section 58 of the NHA provides that "where in the opinion of the Corporation a loan is not being made available to a person (who would normally qualify for an insured loan) ...the Corporation may make such a loan...."[3] This section of the Act has been interpreted in two ways: as a justification for pumping funds into the mortgage market when the private sector is not able to supply the demand and as a source of funds for persons who cannot obtain adequate financing from approved lenders. Interest rates for these loans are adjusted periodically. In recent years, they have been lower than overall market rates.

Although CMHC has severely curtailed its direct lending activities under this section of the Act in recent years, it has remained a lender of last resort in geographical areas not normally serviced by approved lenders. Generally speaking, these loans are made if the potential borrower has been refused at least twice by approved lenders.

Lenders may reject loan applications when the lender has used all of its funds or when the loan is considered marginal in some respect. A loan may be rejected by an approved lender, yet accepted by CMHC, for a variety of reasons such as differences in the way available income is determined (e.g. how much of the spouse's income is included) or in the assessed value of the property. In general,

3. *National Housing Act*, R.S.C. 1970, c. N-10-1970, s. 58(1).

CMHC direct loans must meet the guidelines which apply to NHA insured loans made by approved lenders. These guidelines are discussed in detail in Chapter 5.

Low Income Housing

In the last decade, CMHC's emphasis has shifted from loans to persons normally qualifying for insured loans towards direct funding of housing for persons with low incomes. Central Mortgage and Housing Corporation:

- makes loans to organizations who wish to create low rental housing (NHA Section 15);
- makes loans and grants to government and quasi-government agencies for low rental housing (NHA Sections 43 & 44);
- participates jointly with the provinces in the ownership of housing (NHA Section 40); and
- makes loans directly to low income homeowners under the Assisted Home Ownership Plan (NHA Sections 34.14 and 34.16).

Under Section 15 of the NHA, CMHC will make loans of up to 95 percent of cost to any organization (100 percent for non-profit organizations) that will create a low rental housing project. Non-profit organizations also qualify for "startup" funds of up to $10,000 and a grant of up to 10 percent of the cost of the project. Low rental housing is intended for people with limited financial resources, including special groups such as the elderly and the handicapped. The borrower pays a comparatively low rate of interest but the rentals charged are restricted by an agreement with CMHC. Income limits may also be applied to the residents.

Under Section 43 of the Act, CMHC is empowered to make loans to a province, a municipality or a public housing agency in order to build a public housing project. The maximum loan amount is 90 percent of the total construction or acquisition cost. There are limits on the dollar loan amount per housing unit and rentals charged must be related to the incomes of the tenants. If these rentals are inadequate to meet operating and financing costs, CMHC may provide grants under Section 44 of up to 50 percent of operating losses. In the period 1964 to 1974, the largest proportion (65 percent) of the funds loaned under this program went to the province of Ontario, followed by Quebec which received 17 percent.

Section 40 of the Act provides that CMHC may participate with a province in the ownership of public housing up to a maximum of 75 percent ownership. Rents are based on the income levels of the tenants and all deficits are covered by the federal and provincial governments in proportion to their ownership. In the period 1950-1974, British Columbia received 28 percent of the funds followed by Ontario (20 percent), Nova Scotia (19 percent) and Saskatchewan (15 percent). In recent years, Ontario and Quebec have made little use of this section of the Act.

In June 1973, Sections 34.15 and 34.16, dealing with an *Assisted Home Ownership Program* (AHOP), were added to the NHA. This program provides for direct loans by CMHC and approved lenders and repayment assistance by CMHC to enable moderate income families to purchase their own homes. The AHOP interest rate is set by CMHC and is intended to be close to the current market determined NHA rate. A qualified borrower may have his interest rate reduced in stages to a minimum of eight percent, depending on the need. In addition, the homeowner may qualify for a direct grant of up to $600 per year to assist him in making house payments.

In April 1975, CMHC extended the AHOP program to include loans by approved lenders. At the time of writing, the approved lender program had not yet been implemented but the rules were expected to be similar to those for direct CMHC loans.

Serviced Land

Two major costs of housing are the assembly and servicing of land. The NHA has been amended on numerous occasions to permit the Federal government to offer assistance in these areas with a view to having serviced land brought onto the market at more reasonable prices. Under Section 42, CMHC will make loans to provinces, municipalities and public housing agencies of up to 90 percent of the cost of assembling and developing land suitable for housing. Interest on the loan is repaid at least annually and the loan is repaid as the land is developed and sold. Priority in the allocation of funds is given to land that can be quickly brought to the market. Federal expenditures under this program increased dramatically from $7 million in 1972 to $162 million in 1973, easing off to $81 million in 1974.

Section 40 provides for joint federal-provincial land assembly, with 75 percent owned by the Federal government and 25 percent by the province. Proceeds from the sale of land are shared by the governments in proportion to their ownership.

Loans of up to two-thirds of the cost of sewage treatment plants and trunk sewers are available under Section 51 of the Act. If the project is completed by a certain date, CMHC will forgive 25 percent of the loan.

The Evolution of CMHC Direct Lending Programs[4]

Prior to 1935, most major mortgage lenders were limited to making loans of up to 60 percent of the value of the property. The Dominion Housing Act of 1935 provided for loans for new residential construction of up to 80 percent of value, the loans to be made jointly by private lenders and government. The private portion of the loan was made at market rates while the government portion was at an interest rate below the prime mortgage rate. Losses were shared by the

4. For an excellent review of government activities in the mortgage market until 1957, see H. Woodard, *Canadian Mortgages*, Toronto: Collins Publishers, 1959.

government and the lender. The National Housing Act of 1938 modified the joint lending plan, encouraged lending in isolated communities, and provided for direct government lending for low rental housing projects. These programs were modified and extended in the National Housing Act of 1944. The government was given the authority to make mortgage loans which were not available through approved lenders. In 1946, CMHC was created to administer the Act.

The National Housing Act of 1954 introduced several dramatic changes into the mortgage market. Banks were permitted to become NHA mortgage lenders, provision was made for insured mortgage loans on both new and existing housing, and maximum loan amounts and loan to value ratios were substantially increased. These moves were made to encourage the private sector to place more funds into mortgages and to provide more liberal financing for Canadians wishing to buy their own home. It was not until 1957 that CMHC began making its own direct loans on a major scale.

Following the NHA changes in 1954, banks became active in mortgage lending; however, by 1956 the small growth in bank assets and the heavy demand for business loans had severely cut back bank mortgage lending. This influence, coupled with pressure by the business and government sectors for long-term funds, led to a severe decline in NHA loans. When housing starts continued to decline in 1957, CMHC expanded its direct lending activities substantially. This injection of funds raised housing starts to pre-1956 levels. In 1958, CMHC again increased the amount of their lending which, along with a revitalized private sector, pushed housing starts up to record levels. This high rate of CMHC direct lending continued in 1959, but starts financed by private institutions declined due to other heavy demands for funds.

In 1960, housing starts declined again; this time primarily because banks left the mortgage market completely and did not return until 1967. Under the Bank Act, banks were not permitted to lend at a rate of interest in excess of six percent, and mortgage interest rates during this period were above six percent. To compound the problem, CMHC ran up against its ceiling on total permissible direct lending at the end of 1959. It was not until the middle of 1960 that legislation was passed permitting this ceiling to be raised. This ceiling led to a severe decline in CMHC direct lending in 1960. In 1961, chartered banks remained out of the mortgage market and, because the supply of institutional funds was not adequate to meet the demand, CMHC again interceded strongly with its direct lending activities. Changes in the NHA in 1960 led to the first loans for student housing and sewage treatment projects in 1961.

In the period 1962-1967, CMHC played an active and increasing role in direct mortgage lending. In 1963, the corporation began to finance builders who had not pre-sold the houses. Following revisions in the NHA in 1964, CMHC became more active in the area of loans to provincial and local governments for public housing. Urban renewal loans were instituted in 1964 but never became a substantial CMHC activity. Direct lending by CMHC continued to grow rapidly throughout 1965 and 1966.

The year 1967 was a turning point for CMHC as direct lending under Section 58 reached a level that has not been approached since. In that year, the Bank Act was amended allowing banks to re-enter the mortgage market and to make conventional mortgage loans for the first time. In 1968 and 1969, chartered banks and other financial institutions expanded their mortgage lending due to increasing asset growth and attractiveness of mortgages as investments. For NHA insured loans, the interest rate ceiling was eliminated, the loan to value ratio increased and insurance fees cut in half. This increased lending by the private sector enabled CMHC to cut back on its Section 58 lending and to redirect its efforts toward public and low rental housing. Most of these public housing funds were funnelled through the Ontario Housing Corporation to provide public housing in the province of Ontario.

The period 1970-1972 saw a continuing decline in Section 58 loans and substantial expenditures on low income and public housing. Reflecting an increasing concern for the cost and availability of serviced land, resources were directed toward land purchase and servicing, as well as the financing of sewage treatment plants and trunk sewers. The 1973 revisions in the NHA led to substantial lending under the AHOP plan and for land banks. CMHC has indicated that it intends to invest $100 million per year for the next five years in land assembly.[5]

It should be pointed out that while we have focused on the direct lending activities of CMHC, the corporation is also concerned with the quality of life aspects of housing. The strong commitment to the National Building Code, minimum standards for insured loans, research on housing, and the Neighborhood Improvement Program are all illustrations of this concern.

THE ONTARIO HOUSING CORPORATION

Enabling Legislation

In 1948, the Ontario Legislature passed the Housing Development Act. This Act recognized the provincial government's responsibility for housing, and gave the Lieutenant Governor-in-Council the power to advance, guarantee and make grants for housing purposes.[6] Housing Corporation Limited (HCL) was formed in the same year with the objective of lending money, secured by mortgages, on real estate. HCL was to be financed by the issue of bonds or debentures which would be guaranteed or purchased by the province, and by advances from the Treasurer of Ontario. In fact, HCL was almost totally financed through advances. From 1948 to 1951, HCL made 17,000 second mortgage loans to assist house purchasers by lowering down payments. In the late 1960's and early 1970's, HCL made loans to finance houses built on leased lots and the purchase of condominiums under the Home Ownership Made Easy (HOME) Plan.

5. See, The Honourable S.R. Basford, *National Housing Act Amendments Explanatory Notes on a Bill Introduced in the House of Commons*, Ottawa: CMHC, 1973.

6. See *The Housing Development Act*, R.S.O. 1970, c. 213.

In 1964, the Ontario Legislature passed the Ontario Housing Corporation Act which created the Ontario Housing Corporation (OHC), for the purpose of administering the Housing Development Act and other government housing activities.[7]

An amendment to the Housing Development Act in 1966 permitted the creation of the Ontario Student Housing Corporation (OSHC). Its purpose was to provide student housing accommodation.

In August 1969, the administration of Housing Corporation Limited was transferred from the Treasurer of Ontario to the Department of Trade and Development and became the responsibility of OHC. The Ontario Advisory Task Force on Housing Policy was appointed in November 1972 to study the housing situation in Ontario. As a result of that study, a new Ministry of Housing was created in November 1973 to administer all housing related programs in Ontario. In May 1974, the Ontario Mortgage Corporation (OMC) was formed to take over the mortgage portfolio of HCL and to provide mortgages at below market rates, primarily for the leased lot program. This was followed in February 1975 by the creation of the Ontario Land Corporation, formed primarily to finance land assembly and reporting to the Treasurer of Ontario. All other corporations report directly or indirectly to the Minister of Housing.

Overview of OHC

The Ontario Housing Corporation, with over 1,000 employees, is one of the largest social housing agencies in North America. OHC regularly conducts surveys throughout Ontario (89 in 1974) in an effort to evaluate where and how much public housing is needed. Based on these and other inputs, the corporation, through its rental and home ownership divisions, attempts to increase the supply of appropriate housing. The rental division administers rental programs such as rent-geared-to-income housing and housing for senior citizens and students. The home ownership division administers the subdivision and marketing of land and provides professional services to the Ontario Mortgage Corporation. The programs are known collectively as the *Home Ownership Mase Easy (HOME) plan.* In 1974, OHC had 10 district offices in Toronto and six regional offices in the remainder of the province.

Rental Housing

The Ontario Housing Corporation provides rental housing to families and senior citizens and supplements the rent paid by tenants to private owners. Under the rent supplement program, the landlord receives a rent agreed upon with OHC. The tenant pays a portion based on his income and the balance is financed jointly by CMHC (50 percent), OHC (42 1/2 percent) and the municipality (7 1/2 percent).

7. See *The Ontario Housing Corporation Act*, R.S.O. 1970, c. 317.

OHC acquires its rental properties in three ways: direct purchase, direct construction and builder proposals. Housing units may be purchased directly in order to avoid some of the time lag involved in bringing newly constructed units to market. This technique has been used extensively in Metropolitan Toronto. Under the direct construction approach, OHC purchases land and designs and supervises the construction of a housing project. Public tenders are called and the contract is usually awarded to the lowest bidder. In the case of builder proposals, the builders submit firm price proposals for housing which meets OHC specifications and requirements and OHC chooses among the applications.

Rental housing is available to low income families with rents being geared-to-income. In 1974, of all applicants for family housing in Metropolitan Toronto, 41 percent received their income from employment while 29 percent derived their income from social assistance. The remaining 30 percent received their income from other sources, such as pensions and unemployment insurance benefits.

The rental housing projects are administered directly by OHC or through municipal housing authorities. A housing authority is a body of citizens appointed by provincial Order-in-Council to manage public housing in their community. They hire local staff but operate within OHC guidelines. As of the end of 1974, the 36 housing authorities in Ontario managed over 40 percent of all rental units in the province.[8] This and other characteristics of rental housing are outlined in Table 10-3.

Beginning in 1968, but particularly since 1970, some tenants of rental housing were given the opportunity to purchase homes they had previously rented. To be eligible, monthly principal, interest, and taxes were limited to a maximum of 25 percent of gross income. Mortgages could be amortized for up to 40 years at the OHC rate. The rate could be decreased for low income families to the NHA Section 16 rate to enable the tenant to qualify for the program. Up to December 31, 1974, 981 units were sold in this way.

Student Housing

A survey conducted in 1964 by the Department of University Affairs, indicating a strong and growing demand for student housing at Ontario universities, led to the creation of the Ontario Student Housing Corporation (OSHC) in 1966. This corporation was expected to meet the need for single and married student housing by providing the financing for projects to be built on OSHC or university land. OSHC pays 100 percent of the capital costs, borrowing 90 percent of its funds from CMHC and 10 percent from the Treasurer of Ontario. The university determines who the tenants will be and what rents will apply, although rents normally cover amortization of capital costs, maintenance and administration.

8. For a brief history of local housing authorities in Ontario see, Ministry of Housing, "Housing Authorities Have Come a Long Way Since the Early Days," *Housing Ontario*, Toronto, December 1974.

Although student housing has been given a low priority by CMHC since 1970, in the period 1966-1972, 10,559 units were constructed in Ontario.

Rental Housing Under OHC in 1974 by Type of Tenant, Location and Administration — **Table 10-3**

	Number of Units*
Type of Tenant	
Families	46,169
Senior Citizens	18,700
Total	64,869
Location	
Metropolitan Toronto	28,473
Elsewhere in Ontario	36,396
Total	64,869
Management	
Local housing authorities	27,467
OHC administered	37,302
Industrial housing	100
Total	64,869

* As of December 1974, 7,096 additional units were under construction and 10,972 were at the pre-construction stage.

Source: OHC, *Annual Report*, 1974.

Condominiums

A *condominium* is a form of ownership in which a person has exclusive rights to an apartment or townhouse as well as an interest, along with other condominium unit owners, in "common elements" of the structure such as the grounds, parking spaces and elevators. In 1967, the Province of Ontario passed the Condominium Act providing for this type of ownership in Ontario and setting out the rights and obligations of condominium owners. Initially, lending institutions were hesitant to make loans for condominiums. As a consequence, the OHC began to provide serviced land, second mortgage financing and guarantees to both builders and financial institutions who in turn provided loans of up to 75 percent of value.

Originally, second mortgages were made equal to the value of the land to reduce down payments. Beginning in 1969, and particularly in 1970, substantial sums were devoted to first mortgage loans made directly by OHC. From 1969 to 1974, OHC participated in the financing of over 18,276 units, making it the largest

condominium lender in Canada. All condominium projects are built by the private sector but OHC, as the major lender, ensures that the plans meet their specifications. In addition to first and second mortgage loans, OHC was willing at one time, to guarantee first mortgage loans for condominiums. If a loan was three months in arrears, OHC would take over the loan and indemnify the lender. With the increasing acceptance of condominiums, however, this program has become inactive.

At the beginning of the program, OHC would finance almost any condominium in an effort to encourage acceptance of the concept; however, in recent years, OHC's activities have changed somewhat. OHC now applies restrictions on the type of project and eligibility of tenants in an effort to provide more low income housing. The requirements for the purchase of OHC financed condominiums are now similar to those under the leasehold program.

Leasehold Program

Beginning in 1967, in an effort to lower the cost of financing a home, OHC introduced a plan which allowed a home buyer to lease his serviced lot from OHC, with an option to purchase.

OHC acquires and services land and advertises for proposals from builders to construct certain types of housing with a target price.[9] In order to qualify for housing on leasehold land, the lessee must have been a resident of Ontario for at least one year, occupy the property, have an income below a certain maximum and not have previously participated in any provincial home ownership subsidy program.

The lessee pays a ground rent which is the product of the book value of the property and the current OHC lending rate. The lease may be drawn up for 50 years or there may be an agreement to purchase the property over a 35 year period. A lessee has the option to purchase the land after five years at the current market value at the time the option is exercised. If the property is sold within five years, the seller of the house is permitted to receive the original purchase price, the cost of any improvements, reasonable legal fees and real estate commissions and up to $500 per year capital appreciation. After five years, there are no resale restrictions on the unit. If the home on the leased property is sold within five years, the new lessee must pay a lease payment based on the then current land values and interest rates.

The number of lots marketed during the period 1967-74 was approximately 18,000. OHC had a land bank as of December 1974 in excess of 20,000 acres.

9. The price ceiling on houses built on leased lots was fixed until 1974 when, in response to rapidly increasing construction costs, a flexible target price was introduced. Under this plan, OHC suggests a price and builders submit bids coming as close as possible to the target.

Other Programs

Under the *Integrated Community Housing Program*, OHC assists private developers with the financing of rental housing developments if a percentage of the project is set aside for rent-geared-to-income housing.

The *Ontario Housing Action Program* is a short-term program which was initiated in 1974 to encourage the private sector to provide more housing, particularly for low and moderate income families. In certain designated housing action areas, the Ontario government provides direct grants and special loans to municipalities to encourage the development of serviced land. The Ministry of Housing is also working with other ministries and developers to expedite the planning and approval process.

OHC and CMHC

Throughout the discussion in this section, little mention was made of the relationship between OHC and CMHC. In fact, CMHC provides a substantial portion of the funds loaned by OHC and shares in the subsidies. CMHC provides 90 percent of the capital funds and 50 percent of the operating subsidy in several programs. This points out the obvious need for close cooperation between the Federal government and each province.

Chapter 11

Investment by Chartered Banks

The purpose of this chapter is to discuss the investment activities of chartered banks with particular emphasis on mortgages.

THE BANKING BUSINESS

Canadian chartered banks are characterized by a large number of branches and a relatively high degree of concentration of ownership. There are ten banks which in total have over 6000 branches; of these ten banks, five control 92 percent of all bank assets. Thus, Canadian banks have a highly decentralized branch system which is characterized by centralized processing and control.

It is significant that the size of the banking business and of any individual bank depends primarily on the volume of deposits that that bank is able to attract. There is a strong relationship between the investment activities undertaken by a bank and the degree to which those investment activities attract further deposits. In addition, since bank deposits are limited, banks have sought other profitable activities. The primary alternative utilized is the provision of various financial services. Thus, any lending activity, such as mortgage loans, which leads to deposit generation and the sale of other services, is looked upon favorably.

Bank investment policy depends on the amount of funds available to the bank and on general economic and monetary conditions. The supply of funds is directly related to federal monetary policy, over which banks have minimal control. Each bank does, however, attempt to maximize the share of the money supply that it receives. In periods of rapidly expanding money supply, banks are less restrictive with their funds and, as a result, all sectors of the economy will find funds generally available. However, when money supply expands at a lower rate, funds are less available and must therefore be allocated.

Rather than focusing on the needs of a narrow market, banks, more than any other financial institution, are committed to serve the needs of many types of customers. Thus, they offer a wide variety of services. Chartered banks allocate their funds among business, mortgage, personal loan and government customers. In addition, banks maintain an investment portfolio which has a fairly well-defined, though frequently changing, asset mix. This portfolio satisfies liquidity

and reserve needs as well as other investment objectives. All of the commercial banks set broad policies concerning the proportion of assets held in various securities. This proportion differs substantially from one bank to another, depending on their strategy in the market place.

The percent distribution of the assets of Canadian chartered banks is seen in Table 11-1. Business loans have always been the main-stay of bank activities. During the period 1961 to 1974, the importance of business lending grew substantially. There has been speculation that the ability of prime borrowers to utilize the developing commercial paper market would reduce business dependence on bank borrowing, but available data do not disclose any such trend at this point in time.[1] Business loans have historically been favored by chartered banks for a number of reasons. First, businesses often require short-term self-liquidating loans which are the traditional business of banks. Second, banks establish long-term relationships with businesses that are important to both parties. No bank would jeopardize this relationship to take advantage of a temporary profit opportunity elsewhere. Finally, this is an area in which the banks have developed considerable expertise. Business loans are, in many cases, firmly committed on an annual basis. In tight money periods, this places pressure on the availability of uncommitted funds for such purposes as personal loans.

The rapid growth area for chartered banks over the last decade has been in personal loans. The proportion of assets devoted to personal loans almost doubled from 1961 to 1973, but now, however, shows signs of levelling off. Although personal loans seem to involve somewhat higher risk and more administration these features are offset by higher yields.

The proportion of bank assets held in mortgages declined from 1961 to 1967 but, with the revision of the Bank Act in that year, climbed steadily to a level of almost nine percent in 1974. Bank holdings of mortgages will be discussed in greater detail in a subsequent section of this chapter.

The increase in the proportion of business and personal loans since 1961 has been obtained primarily through a decrease in the proportion of government and other securities held by chartered banks. Thus, one can conclude that banks are investing more heavily in those areas which require somewhat greater expertise, have more associated services and offer higher earnings potential than government or similar investments.

On the liability side, one can see the overwhelming importance to banks of personal savings. While total deposits as a percentage of total liabilities have declined only slightly in the last decade, the mix of deposits has changed significantly. In response to new types of savings accounts and the payment of higher

1. When faced with tight credit conditions, several banks have insisted that their customers utilize the commercial paper market to a greater degree. This led, in the fall of 1974, to a dramatic increase in the use of bankers acceptances as a commercial borrowing mechanism.

Canadian Assets of Canadian Chartered Banks, Selected Years (Percent of Total Assets) — **Table 11-1**

	1961	1963	1965	1967	1969	1971	1973	1974
Bank of Canada Deposits and Notes	7.0	6.9	6.7	6.1	5.3	5.2	5.2	5.0
NHA Mortgages	6.1	5.0	3.8	3.0	3.2	4.2	5.1	4.8
Other Residential Mortgages	-	-	-	0.4	1.1	1.6	2.9	4.0
Personal Loans	9.2	10.6	13.5	14.3	15.5	16.3	17.4	17.1
Business Loans	22.7	24.4	27.2	27.5	27.9	27.7	30.4	30.0
Other Loans	13.8	13.1	14.9	15.7	15.2	11.4	11.0	10.8
Govt. of Canada Securities	24.4	22.1	17.6	18.4	16.3	18.3	12.8	11.8
Other Securities	6.8	6.4	5.7	4.8	4.4	5.7	4.3	4.3
Other Assets	10.0	11.5	10.6	9.8	11.1	9.5	10.9	12.2
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: *Bank of Canada Review*, 1975.

interest rates, more funds are going into time deposits as opposed to demand deposits. The result is that banks may seek increased liquidity in their assets. Banks now offer term notes, negotiable certificates of deposit and savings certificates with various terms. Banks are becoming more heavily involved in offering bankers acceptance facilities and letters of credit than they were in the past. They are also just beginning to utilize their power to issue debentures, although at this point they have not utilized this device to the extent permitted by the Bank Act.[2]

RELEVANT BANK REGULATIONS

Until 1954, chartered banks were not permitted to make loans using real estate as security. The only activities banks were permitted to engage in with respect to mortgages were to make guaranteed mortgage loans under the Farm Improvement Loans Act, to acquire or pledge corporation mortgage bonds, and to take mortgages as subsequent security in the event the bank required added protection for a loan. With the revision of the National Housing Act in 1954, banks became eligible to make and trade CMHC insured mortgage loans and were active in that market until 1959.

2. The Bank Act permits chartered banks to issue debentures with a maturity in excess of five years in a dollar amount up to one-half of the combined Paid Up Capital and Rest Accounts.

In 1959, the maximum NHA interest rate was raised above six percent for the first time. According to the Bank Act, banks were not allowed to charge over six percent on loans and, as a result, they withdrew from the mortgage market. Until 1967, banks participated in the mortgage market only to purchase blocks of mortgages from other financial institutions and CMHC, and to originate mortgages on behalf of CMHC on an agency basis.[3]

In 1967, the Bank Act was revised. The six percent ceiling on interest rates was removed and banks were given the power to make conventional mortgage loans for the first time. The Act, however, restricted the amount loaned on any individual conventional mortgage to 75 percent of the value of the property. Subsequently, banks were permitted to make conventional loans in excess of 75 percent (high ratio loans) if the excess was insured by a registered mortgage insurance company.

There is also a restriction on the total holding by banks of conventional mortgages. Section 75(4):

> "restricts the total principal outstanding at the end of any financial year of each bank, of all loans and advances on the security of residential property by way of conventional mortgages, to 4 percent of the banks deposit liabilities payable in Canadian currency and outstanding debentures at the end of the first year (1967), increasing 1 percent per year, to reach a maximum of 10 percent in total. NHA mortgages are not so restricted and can be made in any volume desired by the bank."[4]

According to this section of the Bank Act, chartered banks, by the end of 1973, were permitted to hold 10 percent of their deposit and debenture liabilities in conventional residential mortgages.

Two other aspects of the Bank Act are relevant to our discussion. According to the 1967 revision of the Act, banks may borrow using subordinated debentures that have a minimum maturity of five years. This restriction on maturity seems to have been passed in order to keep banks from competing directly with trust companies for shorter term debentures. However, as we shall see later, banks are able to circumvent this restriction through their affiliates. Banks are also restricted in their ownership of other companies. A bank is permitted to own no more than 50 percent of the voting rights in a company where it has paid up to $5 million for the shares having voting rights, and no more than 10 percent of the voting rights in any other company or any loan or trust company. The exceptions to this rule are bank service corporations whose functions are ancillary to the banking

3 Technically, banks could not make a loan at an interest rate exceeding six percent but could purchase securities including mortgages at a yield in excess of six percent. Thus, although banks no longer originated for their own accounts, they could place funds in the mortgage market.

4. "Homes for Canadians: Role of the Banks in Their Financing," *C.B.A. Bulletin*, Toronto: The Canadian Bankers Association, January 1971.

function.[5] The impact of this regulation for our purposes is that banks are not in the real estate business whereas their major competitors for mortgage funds, trust companies, have real estate departments. It also prevents chartered banks from taking over trust companies.

The Bank Act is normally revised every 10 years which means that by 1977 the powers of banks will be once again subject to review. Banks and trust companies have already begun to formulate their positions.[6]

BANK MORTGAGE LENDING 1954-1974[7]

Beginning in 1954, banks initiated and rapidly expanded their NHA mortgage lending, believing that a substantial operation was necessary to spread the administrative overhead.

In 1956, banks were faced with heavy business demand and a very tight liquidity position. This situation carried on into 1957 and as indicated in Table 11-2, bank lending activity continued at a relatively slower pace than in 1955. The Federal government in an attempt to support the building industry decided to inject more funds into the housing market. In August of 1957, CMHC set up an agency arrangement with the approved lenders and made $150 million available for housing loans to homeowners or builders. Under the arrangement the lenders originated the loans and serviced the mortgages as the agent for CMHC. In December of 1957, another $150 million was made available. Thus, although banks decreased lending activities on their own account, they were very active under the agency program.

By April of 1958, all of the funds allocated by CMHC for agency loans were utilized and in May of 1958 another $350 million was made available under the same plan. In the meantime, chartered banks expanded their mortgage lending activity over 1957 levels. As seen in Table 11-3, virtually all of this lending was for single family homes.

5. In the fall of 1974, the Royal Bank purchased 100 percent of the shares of International Capital Consultants Limited and renamed it Roymark Financial Services. This was believed to be the first time a Canadian chartered bank purchased a 100 percent interest in a firm which was not a bank service corporation. The firm engaged in corporate financial planning, merger and acquisition and private placement activities. It was thought at the time of acquisition that the bank would sell a portion of the shares or the firm would be reclassified as a bank service corporation thereby permitting 100 percent ownership. For more details see "Other Banks Study 100% Takeover by Royal," *The Globe and Mail*, Toronto, September 6, 1974.

6. For a discussion of some of the banks' proposals see "Next – A Brawl Over the Bank Act," *The Financial Post*, Toronto, November 15, 1973, and for some of the concerns of trust companies, see "Trust Company Chief Opposes New Powers for Chartered Banks," *The Globe and Mail*, Toronto, January 18, 1973.

7. For a brief discussion of bank lending in the 1960's, see "Banking in the Sixties – A Statistical Review," *C.B.A. Bulletin*, Toronto: The Canadian Bankers Association, June 1969.

Mortgage Loans Approved Annually by Chartered Banks, 1954-1974* — Table 11-2

	Millions of Dollars				Percent of All Mortgage Approvals			
	New Residential Property		Existing Residential Property		New Residential Property		Existing Residential Property	
	NHA	Conventional	NHA	Conventional	NHA	Conventional	NHA	Conventional
1954	158.5	—	—	—	100.0	—	—	—
1955	326.2	—	—	—	100.0	—	—	—
1956	158.4	—	—	—	100.0	—	—	—
1957	173.4	—	—	—	100.0	—	—	—
1958	300.4	—	—	—	100.0	—	—	—
1959	175.4	—	—	—	100.0	—	—	—
1960	1.1	—	—	—	100.0	—	—	—
1961	0.2	—	—	—	100.0	—	—	—
1962	—	—	—	—	—	—	—	—
1963	—	—	—	—	—	—	—	—
1964	9.3	—	—	—	100.0	—	—	—
1965	6.1	—	—	—	100.0	—	—	—
1966	—	—	—	—	—	—	—	—
1967	85.0	42.5	—	101.6	37.1	18.6	—	44.3
1968	250.0	82.5	0.1	96.4	58.3	19.2	0.1	22.4
1969	234.2	50.2	0.8	80.1	64.1	13.7	0.2	30.1
1970	338.2	40.9	3.9	110.2	68.6	8.3	0.8	22.3
1971	696.5	154.6	23.1	229.8	63.1	14.0	2.1	20.8
1972	799.4	226.1	94.1	366.8	53.8	15.2	6.3	24.7
1973	572.4	650.5	166.6	798.9	26.2	29.7	7.6	36.5
1974	336.0	667.9	302.7	596.5	17.7	35.1	15.9	31.3

* This table underestimates the total impact of banks in the mortgage area because all mortgages originated by the Bank of Commerce are not included. This bank uses a subsidiary, Kinross Mortgage Corporation, as its mortgage origination arm.

Source: CMHC, *Canadian Housing Statistics,* various issues.

In 1959, there was a substantial increase in demand for longer term funds and a tight money policy. This was accompanied by rising interest rates in the bond market, which rendered mortgages much less attractive than they had been, and thus led banks to decrease their mortgage lending activities to 1957 levels.

Beginning in 1960 with the rise of mortgage interest rates above six percent, banks withdrew from the mortgage market, returning with the revision of the Bank Act in 1967. The immediate response of chartered banks to these 1967 changes was to make a substantial dollar amount of conventional loans. In fact, funds allocated to conventional mortgages exceeded those allocated to NHA mortgages in 1967. During the same year, banks tended to prefer single family mortgages over mortgages on multiple family dwellings. Over 80 percent of bank funds went into the single family area. The relatively high proportion of bank funds going into conventional mortgages in 1967 may have been due to unusually heavy demand in the resale house market coupled with an NHA rate that was not very competitive for a good portion of the year. The non-competitiveness

Mortgages Approved by Chartered Banks, 1957-1974								Table 11-3
	Millions of Dollars				Percent of All Mortgage Approvals			
	New Residential Property		Existing Residential Property		New Residential Property		Existing Residential Property	
	Single Family	Multiple Family	Single Family	Multiple Family	Single Family	Multilple Family	Single Family	Multiple Family
1957	169	4	—	—	97.7	2.3	—	—
1958	284	17	—	—	94.4	5.6	—	—
1959	169	7	—	—	96.0	4.0	—	—
1960	1	—	—	—	100.0	—	—	—
1961	—	—	—	—	—	—	—	—
1962	—	—	—	—	—	—	—	—
1963	—	—	—	—	—	—	—	—
1964	—	9	—	—	—	100.0	—	—
1965	—	6	—	—	—	100.0	—	—
1966	—	—	—	—	—	—	—	—
1967	94	34	96	6	40.9	14.8	41.7	2.6
1968	275	58	90	6	61.4	13.5	21.0	1.4
1969	221	63	77	4	60.5	17.3	21.1	1.1
1970	227	149	110	4	46.3	30.4	22.4	0.8
1971	536	313	233	20	48.6	28.4	21.2	1.8
1972	662	359	426	35	44.7	24.2	28.7	2.4
1973	804	413	888	78	36.8	18.9	40.7	3.6
1974	707	289	775	123	37.3	15.3	40.9	6.5

Source: CMHC, *Canadian Housing Statistics,* various issues.

of the NHA rate may be attributed to the fact that it was pegged to the yield on long-term government bonds and only changed occasionally. This tying of the NHA rate to the long-term government bond yield was discontinued toward the end of 1967. The year 1968 was a year of relatively easy monetary policy. This condition permitted the commmerical banks to return heavily to mortgage lending.

Although the rate of increase in the money supply in 1969 was much slower than in 1968, banks continued to devote a large proportion of their assets to mortgage loans. They were encouraged in this pursuit by anticipated profitability and the encouragement received from the Governor of the Bank of Canada to continue their mortgage lending activities.

The increase in the level of bank mortgage lending continued in 1970, spurred on by an easing of monetary policy and an apparent strategy of allocating a higher proportion of assets to mortgages. During this time, banks devoted a substantially larger proportion of their mortgage funds to multiple family dwellings. This shift reflected, to some extent, the higher net yields which were available in that area, the desire for a balanced portfolio and an increased demand for rental properties.

In 1971, bank mortgage lending increased to its highest level in history. This was at least partly due to the fact that the money supply increased 20 percent in 1971 compared to 10 percent in 1970 and 5.6 percent in 1969.

In 1972, the money supply increased a further 15 percent and monetary conditions remained easy, facilitating the growth in mortgage investment activities by commercial banks. For the second year in a row, chartered banks set a new record for mortgage approvals. Due to revisions of the National Housing Act, NHA mortgage loans for existing residential properties made up a substantial portion of bank business.

As outlined in Chapter 5, private mortgage insurance companies gradually began to challenge CMHC as the major insurer of mortgage loans in the 1970's. As a result, in 1973 and 1974 there was a major shift in bank originations away from NHA mortgages and toward conventional mortgages, many of which were privately insured.

ROLE OF MORTGAGES IN THE ASSET MIX OF BANKS

Mortgages are viewed by banks in two ways; first, as a security with risk, return and liquidity characteristics and second, as a device to increase the volume of related bank business.

The gross yield on mortgages falls between the corporate prime rate and the yield available on personal loans. Banks tend to prefer to make corporate loans for reasons discussed earlier. Both mortgages and personal loans must be serviced. Personal loans have a shorter maturity (one to two years), a smaller average amount, and a higher default rate. Mortgages, although they require greater initial expertise on the part of the manager, have lower default rates and servicing is easily mechanized. Mortgages have a reputation for being illiquid but this appears to have had virtually no impact on banks. Mortgages are seen as providing their own liquidity in terms of principal and interest payments. Although banks make five year term mortgages, they look upon them as long-term investments because they feel obligated to renew the mortgage at the end of each five year term. Thus, while the five year term increases flexibility as the interest rate is periodically reviewed, it is not perceived as enhancing liquidity. While mortgage liquidity is a consideration, banks rely on other investments, such as treasury bills and government or high grade corporate bonds, to provide liquidity. Even high grade bonds, however, are not all that marketable in Canada. This is especially true if someone wants to sell a large quantity or if economic conditions are such that other institutions are trying to sell their bonds as well. One mechanism that banks may use if they are strapped for funds is the sale of a block of mortgages to an affiliate. The relationship between banks and their affiliates is discussed more fully in a later section.

Perhaps the most outstanding feature of bank mortgage lending is the feeling on the part of bankers that the mortgage loan service attracts customers. As a result, banks generally prefer to give out single family mortgages rather than multiple

family mortgages. In this way, they have an opportunity to establish personal contact with potential customers.

Banks have, in the past, invested heavily in mortgage loans on new rather than existing residential property for two major reasons. First, at one time the only loans banks were permitted to make were for NHA insured mortgages, all of which were on new property. Second, from a competitive standpoint, with banks relatively new to the mortgage business, it was much easier for chartered banks to begin dealing with traditional clients, namely builders, rather than to compete for mortgages on existing houses. Although banks had an extensive branch system, they had not developed a network of relationships with real estate agents which would lead to a large volume of loans for existing homes.

According to the Bank Act, the proportion of deposits and debenture liabilities held in the form of conventional residential mortgages has a maximum ceiling of 10 percent. As indicated in Table 11-4, banks have not reached that maximum at the present time and are unlikely to approach it in the near future. However, even if they did, it is unlikely that this legislation would represent any severe constraint on banks as they have bank affiliates which can make mortgage loans and finance the loans in the market.

Conventional Mortgages as a Proportion of Chartered Bank Deposits and Debenture Liabilities at the End of Selected Periods, 1970-1974 (percent) **Table 11-4**

Year	Month	Proportion
1970	June	1.13
	December	1.19
1971	June	1.38
	December	1.75
1972	June	2.01
	December	2.32
1973	June	2.70
	December	3.40
1974	June	4.49
	December	4.54

Source: *Bank of Canada Review,* various issues.

Although existing legislation is unlikely to constrain mortgage lending for some time, it seems reasonable to assume that Canadian chartered banks will ultimately stabilize the proportion of their funds loaned out as mortgages. This proportion has climbed steadily for a number of years.

The degree to which banks initiate mortgages is based upon their ability as financial institutions to absorb and sell those mortgages to other investors. Consequently, the volume of bank mortgage lending in the future will depend on the ability to competitively attract savings, the extent to which the money supply is expanded and the extent to which banks choose to issue debentures and originate mortgages on behalf of other investors. Another factor is the degree to which banks are able to employ affiliates which can attract deposits or investment funds in the market. As bank portfolios become larger, a major initiation effort will be required to re-invest the payments and prepayments received from borrowers.

ALLOCATION OF MORTGAGE FUNDS

Once a bank has determined the proportion of available funds that it intends to devote to mortgages, it then must allocate these funds by region in Canada. As a rule, banks ask their division managers to estimate the demand for mortgage funds in their region for the coming year. The total request for funds by regional managers normally exceeds the supply of funds that the bank is willing to allocate. Typically, funds are allocated in proportion to the demand from all of the regions. In a presentation to the Western Economic Opportunities Conference in Calgary in 1973, the Canadian Bankers Association provided certain data, portions of which are reproduced in Table 11-5. These data suggest that banks do not allocate mortgage funds to regions in proportion to deposits solicited.

Before informing the head office of the regional need for funds, the regional bank manager will probably consult with each branch manager in his region to determine their needs in the coming year. The regional office then distributes the funds throughout the year in accordance with the flow of applications received by the individual branches. The demand for funds by various branch managers appears to depend on the willingness and ability of the manager to originate mortgages and on the pressure from customers. Thus a potential borrower's reception could differ between banks and between branches of the same bank. It should be kept in mind that any allocations made by banks at the beginning of the year are made on a preliminary basis and there is some degree of flexibility as the year goes on.

In a speech given by Mr. C.L. Townsend, Assistant General Manager of the Toronto-Dominion Bank, some of the factors that banks take into account when allocating their mortgage funds were enumerated. Banks try to ensure:[8]

a) "that the allocation is spread fairly across the country;

b) that..(there is)...a steady, continuous lending operation throughout the calendar year without 'running dry' and having to 'turn off the tap';

c) that a large proportion goes into new construction;

8. C.L. Townsend, Seminar on Real Estate Finance, University of Alberta, April 28, 1971.

d) that good individual applications from customers can always be taken care of;

e) that there is good effective demand and potential demand in the areas and to the developers we assist with mortgages on units being built for speculative sale; and

f) that our own customers have priority."

Selected Statistics on the Distribution of Bank Assets and Liabilities in the Four Western Provinces as of 1973 — **Table 11-5**

	Manitoba	Saskatchewan	Alberta	British Columbia
Provincial Population as % of Canada	4.5	4.1	7.6	10.4
Personal Income in 1971 as % of Canada	4.3	3.5	7.5	11.1
Bank Branches as % of Total for all Banks	5.0	5.4	8.7	11.3
Deposits in 1972 as % of Total for all Banks	4.6	3.8	8.4	12.1
NHA Mortgages Outstanding as a % of all Loans	6.6	2.6	15.1	12.9
Other Residential Mortgages Outstanding as % of all Loans	2.5	1.1	6.6	32.7
Total Mortgages Outstanding as % of all Loans	5.5	2.2	12.7	18.4

Source: *The Banks and the West*, The Canadian Bankers Association, Toronto, July 1973.

BANK AFFILIATES

Chartered banks have a variety of foreign and domestic affiliates which specialize in banking related activities. A number of banks have sponsored real estate investment trusts, mortgage investment companies and mortgage insurance companies. These firms are discussed in other chapters. Other firms have been created for the purpose of investing in mortgages originated by chartered banks; our objective in this section is to outline the activities of some of these firms.

RoyMor Limited was incorporated in Quebec in 1968, principally for the purpose of purchasing NHA and conventional first mortgages from the Royal Bank. Conventional mortgages are guaranteed against loss by the bank for the remainder of the first five years of the term of each mortgage. All mortgage loans held by RoyMor are serviced by the Royal Bank. The policy of RoyMor is to purchase

mortgages at prices such that principal and interest payments along with other available funds are adequate to cover all operating expenses, taxes and debt service requirements of RoyMor. As of the end of 1974, RoyMor held over $339 million in residential mortgages of which 66 percent were conventional and 34 percent NHA. Over 90 percent of the portfolio had a remaining term of five years or less, while 7 percent were over 15 years. RoyMor raises its funds primarily through the sale of investment certificates but also through short-term promissory notes and longer term debentures.[9] The effect of the agreement between RoyMor and the Royal Bank is to make these debt instruments almost as secure as liabilities of the bank itself.

In the past, the Royal Bank made substantial use of a subsidiary of RoyNat called TanYor Limited. Under this relationship, the Royal Bank made a 75 percent first mortgage and TanYor took a subordinated interest in a first mortgage so that the bank in effect could get into the high ratio conventional mortgage business. When the Canadian and British Insurance Companies Act was changed and the Royal Bank became a sponsor of Insmor Mortgage Insurance Company, the business of TanYor ceased.

In 1973, the Bank of Nova Scotia set up a federally incorporated loan company called B.N.S. Mortgage Corporation. Wood Gundy, through Bluenose Investments Limited, owns half of the voting shares of the firm. The principal business of the corporation is to hold mortgages which it purchases from the Bank of Nova Scotia. As of December 31, 1974, total mortgage holdings were $51 million of which approximately 40 percent were NHA and 60 percent were conventional. All mortgages had a term of five years or less. B.N.S. Mortgage is financed through the sale of short and medium term notes, debentures and bank lines of credit.

Scotia Covenants Limited is an investment company within the meaning of the Investment Companies Act of Canada which came into force on January 1, 1972. Scotia Covenants is 100 percent owned by Scotia Covenants Group Limited which is currently 49 percent owned by the Bank of Nova Scotia; the remainder of the shares are owned by a variety of institutions.[10] Scotia Covenants Limited raises funds which it makes available to its wholly owned subsidiary, Central Covenants Limited. Until 1970, the major business of Central Covenants was to participate with institutional lenders in order to make joint mortgage loans of up to 90 percent of the value of properties. Most institutions had been limited to loans of 66 2/3 percent and later 75 percent of value. After regulatory changes in 1970 permitted high ratio conventional insured loans on the part of financial

9. See *RoyMor Limited Offering Circular*, Toronto: Wood Gundy, April 30, 1975.

10. Some of these companies include: Aluminum Company of Canada, The Canada Life Assurance Company, Confederation Life Insurance Company, The Eastern Canada Savings and Loan Company, The Equitable Life Insurance Company of Canada, Greenguard Limited, The Imperial Life Assurance Company, Industrial Life Insurance Company, Investors Syndicate Limited, and Sun Life Assurance Company of Canada.

institutions, Central Covenants changed its policy to one of using its own funds to make first mortgage loans through mortgage correspondents, some of whom were its shareholders. The investment policy differs from that of the other bank affiliates previously discussed because it complements rather than supplements the Bank of Nova Scotia investment strategy. For example, the bank invests in prime urban single family dwellings, whereas the affiliate investment policy covers non-urban residential properties, vacation homes, commercial and industrial loans, rental apartments, townhouses and condominiums. All mortgage loans are insured. As of December 31, 1974, 17 percent of the mortgage portfolio consisted of joint mortgages, a carryover from the firm's pre-1970 business, while 83 percent of the portfolio was made up of insured first mortgage loans. Of the $123.2 million of mortgage holdings on December 31, 1974, 88 percent were conventional and insured by the Mortgage Insurance Company of Canada, while the remainder were insured under the NHA. The firm raises its funds through short and intermediate term notes and longer term debentures.

Kinross Mortgage Corporation, a subsidiary of the Canadian Imperial Bank of Commerce, was founded in 1963 at a time when the Bank Act did not permit banks to make conventional mortgage loans. Kinross was incorporated under the Loan Companies Act and therefore was not restricted in the same way that banks were. A revision of the Bank Act eliminated the original need for Kinross but the firm continued to perform a useful function. Kinross is run somewhat differently from other comparable bank affiliates in that it conducts all of the mortgage origination activity for the Canadian Imperial Bank of Commerce, and, in addition, acts as an investor in mortgages. Once the mortgages have been originated, all servicing and administration is done by the bank. As of the end of 1974, Kinross held mortgages of $464 million of which 91 percent were conventional and nine percent were NHA. The bulk of these funds was raised through the issue of debentures.

First Canadian Investments Limited (initially called Firstbank Investments), owned jointly by the Bank of Montreal and Royal Trust, was incorporated in Ontario in 1970 for essentially the same purpose as RoyMor. The firm issues promissory notes and debentures, lending the proceeds to its wholly owned subsidiaries (Filmor Limited, Filmor Investments Atlantic Limited and Filmor Western Limited) which in turn purchase fully insured residential first mortgages from the Bank of Montreal. The subsidiaries may purchase mortgages from originators other than the bank. As of October 31, 1974, the subsidiaries held $72.6 million in residential mortgages all of which were NHA insured and over half of which had a remaining term of five years or less.

Tordom Corporation was incorporated in Ontario in 1969 principally for the purpose of investing in first mortgages purchased from its major shareholder, The Toronto-Dominion Bank. A part interest in Tordom is held by Canada Permanent Trust Company. As of December 31, 1974, the corporation held mortgages valued at $292 million of which 85 percent were conventional and the remainder NHA. The bulk of the corporation's funds were derived from notes with remaining terms of one to five years.

As can be seen, several bank affiliates have been created, all with slightly different and evolving objectives, but all purchasing first mortgage loans originated by a bank. These affiliates are useful to the banks for several reasons. In some cases they provide a captive customer for the bank's mortgage servicing and origination activities. As has been discussed, banks benefit both directly and indirectly from this situation. A second desirable characteristic of the affiliate is that it can tap a section of the capital market not readily accessible to banks. Affiliates can, for example, issue long-term debentures in excess of the total dollar amount that banks are permitted to hold. They may also issue term notes with maturities of under five years and investment certificates which compete directly with trust companies. Having an affiliate allows the bank to increase or decrease the rate paid by the affiliate for funds, without forcing the bank to manipulate its own borrowing rate as frequently. A final and perhaps most important advantage of the affiliate is that it may act as a buffer when the bank overcommits itself to mortgage loans and subsequently finds itself short of funds.

Chapter 12

Life Insurance Companies

The purpose of this chapter is to outline the various investment activities of life insurance companies making special reference to their mortgage investment practices. There is no discussion of property and casualty insurance companies operating in Canada as they invest only a small proportion of their total assets in mortgages.[1]

THE LIFE INSURANCE BUSINESS[2]

At the end of 1973, there were 163 life insurance companies operating in Canada. Of these, 83 were Canadian incorporated, nine were British and the remaining 71 were foreign, primarily American. Of the Canadian firms, 28 were registered under provincial laws while the remainder were federally registered. All British and foreign companies must be federally registered. The Canadian assets of all federally registered companies are shown in Table 12-1. It should be noted that this Chapter will deal only with Canadian assets of all firms which are federally registered. Thus, all assets of provincially registered firms and non-Canadian assets, such as foreign securities or real estate holdings, of all federally registered firms are excluded.

Life insurance companies sell contracts or policies which provide for future payments under varying circumstances. The simplest life insurance policy provides for the payment of a certain amount to a beneficiary upon the death of the policy holder. Other policies combine life insurance protection and savings plans. Insurance companies also sell annuities which are generally intended to provide income after retirement until death. Under some annuity plans the amount of the

1. As of December 31, 1973, 2.65 percent of property and casualty insurance company assets, or $61 million, was invested in mortgages. In addition, $143 million, or almost 21 percent of the total assets of the accident and sickness branches of life insurance companies operating in Canada, were invested in mortgages. Fraternal benefit societies held $49 million, or 10 percent of their assets, in mortgages in 1973.

2. For a good discussion of the types of insurance policies available and their purposes, see *Life Insurance – A Canadian Handbook*, Toronto: The Canadian Life Insurance Association, 1968. For a summary of useful facts about life insurance, see *Facts '74 – Canadian Life Insurance*, Toronto: The Canadian Life Insurance Association, 1974.

Canadian Assets of Federally Registered Insurance Companies, 1973*
(excluding segregated funds) **Table 12-1**

	Assets	
	$ millions	**Percent**
Canadian	12,749	75.1
British	1,374	8.1
Foreign	2,843	16.8
Total	16,966	100.0

* This table includes only those assets of federally registered Canadian, British and Foreign Insurance companies which are invested in Canada. Provincial company assets estimated to have been excluded from this table totalled $970 million at the end of 1973. The assets of Canadian companies are at book value while those of other firms are at market value.

Source: *Report of the Superintendent of Insurance for Canada,* 1973.

regular annuity payment is guaranteed. Other plans offer annuity payments, the amount of which varies with the return earned on the invested premiums. The result of these various savings and life insurance plans is that insurance companies take in a large number of regular premiums and are committed to a large number of insurance and annuity payments which in aggregate are relatively predictable. Since for many years the premiums received have exceeded the policy outlays, insurance companies have supplied large sums of money to other sectors of the economy.

Although insurance company obligations are, perhaps, more predictable than those of other firms, there are a number of uncertainties which could cause liquidity problems. Some individuals and firms leave their dividends in the form of deposits with insurance companies which may be withdrawn on short notice. Also, many insurance policies build up a "cash value" which the policy holder can claim in the event the policy is discontinued. Holders of certain types of policies are permitted to borrow money from the insurance company on the cash surrender value of their policy. Another uncertainty is caused by the unpredictability of the sale of new insurance policies.

LEGISLATIVE RESTRICTIONS ON INSURANCE COMPANY INVESTMENTS

Canadian life insurance companies may be either federally or provincially incorporated. All federally incorporated, foreign and British insurance companies must be registered with the Department of Insurance. Provincial companies may voluntarily register. All registered Canadian and British firms are subject to the Canadian and British Insurance Companies Act (CBIC Act); all foreign companies are subject to the Foreign Insurance Companies Act. For our purposes, the Canadian and British Insurance Companies Act adequately summarizes the legislation that applies to all insurance companies operating in Canada.

The Canadian and British Insurance Companies Act specifies the types of investments in which insurance companies may place their funds. The investments include:

- bonds, debentures or other securities issued by or guaranteed by municipal, provincial and certain national governments;
- bonds issued by an authority which acts as a public utility;
- securities of certain world agencies;
- equipment trust certificates;
- bonds or debentures fully secured by real estate, plant and equipment or eligible securities;
- bonds or debentures of, or guaranteed by, corporations whose preferred or common shares are eligible investments or whose earnings over the past five years have been sufficient to attain a stated multiple of interest charges on all long term debt;
- guaranteed investment certificates of Canadian trust companies whose preferred or common shares are acceptable investments;
- preferred or common shares of corporations, if those corporations have met certain minimal dividend and earnings requirements over the past five years;
- mortgages or hypothecs up to 75 percent of the property value or higher if the excess is insured or guaranteed;
- real estate for the purpose of earning income; and
- investments under the *basket clause.*[3]

Investments permitted under this Act take on added significance when one realizes that this Act is frequently used as a guide for legislation enumerating the investment restrictions on other financial institutions.

The law with respect to mortgage investments by life insurance companies has changed over time. Beginning in 1910, loans could be made on the security of mortgages as long as the loan did not exceed 60 percent of the value of the real estate. This proportion was increased to 66 2/3 percent of the value in 1960 and to 75 percent in 1964. Insurance companies are permitted to lend funds in excess of 75 percent of the value of the property mortgaged when the excess is insured

3. A *basket clause* is one which permits an institution to place its funds in investments not otherwise permitted under the Act. The CBIC Act permits seven percent of the book value of investments to be of this type. The reasons for having a basket clause were succinctly put in an address by Richard Humphreys, Superintendent of Insurance, at the Real Estate Conference for Pension Funds on September 25, 1973 who stated, "When a new investment instrument comes onto the market, it is not for the legislators or the government officials to decide in advance that this represents a good quality investment. Rather, the investment should be allowed to become seasoned in the investment community and after it proves itself, and suitable criteria can be devised, it can then be included amongst the eligible investments".

by a private, federally registered company or by the Central Mortgage and Housing Corporation under the National Housing Act.

Although the Act permits investments in real estate, it restricts permissable investments to income producing real estate. Real estate is eligible if a lease is made to, or guaranteed by, a government or corporation whose preferred or common shares are eligible investments. The lease must provide a reasonable return over the period of the lease and must repay at least 85 percent of the amount invested in the property within the duration of the lease or 30 years, whichever occurs sooner. When the property is not leased as above, documentation must be presented indicating that in the previous three years the property yielded a net revenue sufficient to yield a reasonable return in the future.[4]

Section 81 of the CBIC Act deals with the maintenance of separate funds in respect of business other than life insurance. These are commonly known as *segregated funds.* If an insurance company issues a policy, the value of which depends on the market value of a specified group of assets in a segregated fund, the insurance company may invest those segregated funds in any proportions of various assets that they see fit. However, the insurance company still must invest the funds in investments permitted under the CBIC Act and the basket clause applies to each segregated fund. Even within this context, however, the insurance company cannot use the basket clause to lend on the security of mortgages, not otherwise permitted, to invest in any single real estate investment which exceeds one percent of the book value of the insurance company's assets, or to invest in the common shares of firms, such as other life insurance companies, forbidden by the CBIC Act.

In addition to restricting the investment of insurance company funds to particular types of assets, the Act specifies the maximum proportions of company funds that may be invested in certain types of assets. Common stock is limited to 25 percent of the book value of the insurance company's assets. The maximum book value of certain types of real estate is limited to 10 percent of the book value of the company's assets.[5] The total investment of a company in any one parcel of real estate or leasehold cannot exceed two percent of the book value of total assets; if the real estate has been purchased under the basket clause, the maximum is one percent. The restriction of real estate investment to income producing properties has apparently been done to prevent insurance companies from speculating with vacant land and marginal real estate.

With some exceptions, an insurance company cannot purchase over 30 percent of the common shares of any corporation or the shares of another life insurance company. Subject to a limit on the total dollar amount invested, an insurance

4. See *Canadian and British Insurance Companies Act*, R.S.C. 1970, c.I-15, s. 63(1)(p) and s. 63(1)(q).

5. There is no limit on real estate for the production of income if it is leased to certain approved lessees and the net revenue meets certain minimum requirements. See *Canadian and British Insurance Companies Act*, R.S.C. 1970, c.I-15, s.63(1)(q).

company may purchase any proportion of the shares of a foreign life insurance company, any Canadian company selling insurance other than life insurance, any corporation formed to provide the firm with advisory, management or sales distribution services in respect of insurance or annuity services, any corporation incorporated to offer participation in an investment portfolio, any corporation in the real estate investment business or any other corporation carrying on a business which is ancillary to the insurance business.

GENERAL INVESTMENT PRACTICES OF LIFE INSURANCE COMPANIES

As discussed, insurance companies receive funds for a variety of purposes including various types of insurance and annuities. The objective in this section is to discuss how life insurance firms have invested these funds. An examination of segregated funds is deferred until Chapter 14 which deals with pension funds.

Table 12-2 shows how life insurance companies have invested their non-segregated funds over the last decade. The large investment in bonds and mortgages indicates that most insurance company commitments are both long term and relatively predictable. For many years the proportion of bonds has been steadily declining, and until 1969, this decline in bonds was matched by a steady growth in the proportion of mortgages held. Since 1969, however, the proportion of assets held in the form of mortgages has begun to decline. This relative decline in fixed income securities has been balanced by an increased growth in the proportion of assets devoted to stocks and real estate; a shift in emphasis prompted by the search for higher returns. Policy loans made by life insurance companies have always been substantial and varied in response to economic conditions. At present, they are at a record high level.

Canadian Assets of Federally Registered Life Insurance Companies Operating in Canada* (excluding segregated funds) **Table 12-2**

	1963		1968		1973	
	$ millions	percent	$ millions	percent	$ millions	percent
Bonds	4,579	44.6	4,856	37.8	6,185	36.5
Stocks	313	3.0	597	4.7	1,127	6.6
Mortgage Loans	4,463	43.3	6,065	47.3	7,330	43.2
Real Estate	349	3.4	505	3.9	969	5.7
Policy Loans	398	3.9	554	4.3	885	5.2
Cash & Other	198	1.8	253	2.0	470	2.8
Total	10,318	100.0	12,830	100.0	16,966	100.0

*This table includes only those assets of federally registered Canadian, British, and foreign insurance companies which are invested in Canada. Provincial company assets excluded from this table totalled $700 million in 1963, $800 million in 1968, and $850 million in 1973. The assets of Canadian companies are at book value, while those of other firms are at market value.

Source: *Report of the Superintendent of Insurance for Canada,* 1963, 1968 and 1973.

Although bonds have declined in significance over the years, they still represent a large proportion of life insurance company investments. Corporate bonds have had a larger role to play than government securities, making up 70 to 85 percent of the bond portfolio. In the last two decades, the makeup of the government sector of the bond portfolio has changed substantially. At one time, Government of Canada bonds were considered the most important holding but they now rank behind provincial and municipal securities. Holdings of provincial government securities now exceed the combined holdings of federal and municipal securities.

Until the stock market crash of 1929, one major insurance company held a large proportion of its assets in common and preferred stocks. The financial embarassment caused to this insurance company by the crash led to legislation in 1932 restricting investments in common stocks to 15 percent of the book value of total assets. Although this restriction has been eased somewhat, insurance companies still have a relatively small proportion of their assets in stocks. Throughout the period 1940 to 1960, life insurance companies invested about three percent of their assets in Canadian stocks. Beginning in the 1960's, however, this proportion of assets devoted to stocks rose rapidly perhaps reflecting a prevailing philosophy that in the long run, a well diversified portfolio of stocks could out-perform a bond portfolio. Over the last two decades, the proportion of the stock portfolio devoted to preferred shares relative to common shares fell substantially from 35 percent in 1953 to seven percent in 1973. The bulk of the common shares are in industrial firms.

Real estate was not viewed as a portfolio investment until 1947. In that year, insurance companies were permitted to invest in real estate through the newly created basket clause. Through the years, insurance companies have been provided with greater powers to invest in real estate, including the power to own real estate subsidiaries. This power enables insurance companies, through their subsidiaries, to own vacant land for development. Insurance company real estate investment is intended to provide an above average return and a hedge against inflation. It, for the most part, takes the form of apartment buildings, town houses, shopping centres, office buildings, warehouses and light industrial buildings. The developer or contractor either builds the building and sells it to an insurance company or is employed by the company to develop the project on their behalf. In some cases, the insurance company participates on a joint venture basis with a developer or another institution.[6] As of December 31, 1973, 13 Canadian life insurance companies had invested in the shares (in many cases 100 percent of the shares) of 56 real estate corporations. As can be seen in Table 12-3, the same insurance companies provided the bulk of the long-term capital for these ventures.

As mentioned earlier, insurance purchasers may borrow up to the cash surrender value of their insurance policy. On policies written before September 1, 1968, the

6. For a discussion of some of these arrangements, see "Canada's Life Insurance Companies Move into Real Estate Investment," *The Financial Post*, Toronto, April 21, 1973.

Financing of Real Estate Subsidiaries By Life Insurance Companies, 1973 — **Table 12-3**

	Total Capitalization in $ millions	Held By 13 Life Insurance Companies in $ millions
Mortgage Loans	80.2	59.1
Bonds	53.8	43.4
Preferred Stock	17.7	16.8
Common Stock	16.9	13.3
Total	168.6	132.6

Source: *Report of the Superintendent of Insurance for Canada,* 1973.

maximum rate charged by insurance companies was six percent. Since that time, policies have been written with a higher rate but the majority have not exceeded eight to eight and one half percent. In periods of rising interest rates, borrowers have approached life insurance companies for policy loans in increasing numbers. As indicated in Table 12-4, policy loans as a percentage of insurance company assets rose rapidly until 1970. Since then the proportion of policy loans to total assets has been relatively stable, although the prediction of the level of policy loans has been a problem for individual firms. Insurance companies see two undesirable aspects to policy loans. First, since policy loans are unpredictable, they make the management of liquidity more difficult and second, since they are at a relatively low rate, the overall return on investments is lowered.[7]

Canadian Policy Loans by Federally Registered Life Insurance Companies, 1963-1973 — **Table 12-4**

Year	Canadian Policy Loans Outstanding in $ millions	Policy Loans as a Percent of Total Canadian in $ millions
1963	385	4.0
1964	398	3.9
1965	410	3.7
1966	450	3.9
1967	486	4.0
1968	554	4.3
1969	659	5.0
1970	760	5.5
1971	784	5.3
1972	813	5.1
1973	885	5.2

Source: *Report of the Superintendent of Insurance for Canada,* various issues.

7. For a more detailed discussion of policy loans, see "There's Still A Bargain Left in Life: Policy Loans," *The Financial Post*, Toronto, April 27, 1974 and "Cheapest Loans in Town," *The Financial Post*, Toronto, September 22, 1973.

As discussed earlier, insurance companies are permitted to invest up to seven percent of the book value of their assets in investments not otherwise permitted. As seen in Table 12-5, the basket clause is not being used up to the maximum permitted. In recent years, the bulk of investments permitted under this section of the Canadian and British Insurance Companies Act has been in real estate.

As outlined in Table 12-6, the Canadian asset portfolio of insurance companies appears to differ by country of incorporation. British firms hold substantially more stock and foreign firms substantially less than their Canadian counterparts. Foreign firms place a heavier emphasis on bonds and mortgages.

Canadian Life Insurance Company Investments Under the Basket Clause, Section 63(4), 1973 — **Table 12-5**

	$ millions	Percent
Bonds	106.3	16.0
Stocks	100.6	15.2
Real Estate	456.0	68.8
Total	662.9*	100.0

* In 1973, this represented 3.62 percent of all domestic and foreign investments of Canadian life insurance companies.

Source: *Report of the Superintendent of Insurance for Canada,* 1973.

Canadian Assets of All Federally Registered Life Insurance Companies by Country of Incorporation, 1973* (excluding segregated funds) — **Table 12-6**

	Canadian		British		Foreign	
	$ millions	Percent	$ millions	Percent	$ millions	Percent
Bonds	4,416	34.6	462	33.6	1,307	46.1
Stocks	782	6.1	340	24.7	5	—
Mortgages & agreements for sale	5,593	43.9	432	31.4	1,305	46.0
Real Estate & ground rents	821	6.4	84	6.4	64	2.3
Policy Loans	674	7.6	54	3.9	157	5.6
Cash & other	463	1.4	2	—	5	—
Total	12,749	100.0	1,374	100.0	2,843	100.0

* This table does not include the foreign assets held by federally registered companies, amounting to approximately $5,670 million in 1973. These assets related almost entirely to liabilities outside Canada. The Canadian company assets are at book value while those of British and foreign firms are at market value.

Source: *Report of the Superintendent of Insurance for Canada,* 1973.

Summary totals conceal a significant difference in investment strategy from one life insurance company to another. Table 12-7 shows the assets of two selected life insurance companies. As indicated, Manufacturers Life has placed more emphasis on equity related investments such as real estate and stocks. Within the fixed income portion of the portfolio, London Life has focused on mortgages while Manufacturers has split their investments between mortgages and bonds. Most Canadian companies hold portfolios between these two extremes.

Canadian Assets at Book value of London Life and Manufacturers Life as of December 31, 1973* (excluding segregated funds)

Table 12-7

	London Life		Manufacturers Life	
	$ millions	Percent	$ millions	Percent
Bonds	330.7	16.9	440.9	37.7
Stocks	27.3	1.4	75.9	6.5
Mortgages	1,345.1	68.7	333.2	28.5
Real Estate	21.7	1.1	200.8	17.2
Policy Loans	118.9	6.1	43.6	3.7
Cash and Other	115.1	5.8	74.0	6.4
Total	1,958.8	100.0	1,168.4	100.0

* Manufacturers Life carries on a substantial business in other countries. As of 1973, the book value of these assets was $1,286 million.

Source: *Report of the Superintendent of Insurance for Canada,* 1973.

MORTGAGES IN THE PORTFOLIO

Insurance companies have long-term relatively predictable liabilities. While there is a potential liquidity need associated with policy loans and the "cashing in" of life insurance policies, life insurance companies have not had a severe liquidity problem for many years. This has naturally led insurance companies to invest in long-term fixed income securities such as bonds and mortgages and diversified portfolios of common stocks.

The publicly issued bonds of Canada's largest corporations are more marketable, with lower origination costs and a lower yield than mortgages. Privately placed debt offers much less marketability but a higher yield than other bonds and terms more tailored to the lender. Both private placements and mortgages occasionally offer an opportunity for equity participation.

Fluctuations in the asset value of a portfolio are a problem as the insurance company has to maintain actuarial reserves against anticipated future liabilities. One company indicated that it preferred mortgages to municipal and corporate bonds because the latter are carried into a year-end solvency test at market values whereas mortgages are carried at their capital balance outstanding.[8] It is conceivable that should an efficient secondary market for mortgages be developed, life insurance companies would be required to carry mortgages at market value, which could discourage some of the present investment in mortgages.

RESIDENTIAL AND OTHER MORTGAGES

The proportion of life insurance company assets allocated to mortgages grew rapidly following World War II and in the last decade has stabilized at approximately 40 percent of assets. It should be noted, however, that the proportion of assets in residential mortgages has declined steadily in the last fifteen years. Table 12-8 indicates that the proportion of mortgages going into commercial and industrial properties increased from 23 percent in 1959 to a rather stable 50 percent of total mortgage approvals in the 1970's. In spite of this shift in emphasis, some firms prefer residential and in particular single family mortgages because they are perceived to have lower risk than commercial or industrial mortgages. With commercial and industrial properties, there is a risk of overbuilding or recession during which time it may be quite difficult to place a tenant in the commercial property. It is contended, however, that demand will still exist for residential properties, even in recessions.

SINGLE FAMILY AND MULTIPLE FAMILY MORTGAGES

As seen in Table 12-9, the proportion of residential housing funds allocated by insurance companies to single family housing has declined in the last decade. In 1958, over 60 percent of mortgage approvals were for single family housing but during the 1960's and early 1970's, the balance shifted to multiple family property mortgages. In 1974, single family mortgages exceeded multiple family mortgages primarily because builders curtailed construction of multiple family dwellings.

Several reasons are given for the shift from mortgage loans on single family housing to loans on multiple family housing units.[9] One of the more common reasons is the higher rate of return, after administrative costs, on an apartment loan over that of a single family unit. A second reason is that apartment build-

8. Section 71(4) of the Canadian and British Insurance Companies Act specifies that the maximum value for securities issued or guaranteed by the government of Canada, the United Kingdom, the United States or Canadian provinces is the amortized value. For all other securities, the book value is to be used unless the aggregate of market values is below book values in which case the book value is reduced by the difference employing a three year averaging rule.

9. For a discussion of these factors see *Submission of the Canadian Life Insurance Association to the Federal Task Force on Housing and Urban Development*, Toronto: The Canadian Life Insurance Association, 1968.

Mortgage Loans Approved by Insurance Companies in Canada, 1959-1974 — **Table 12-8**

	New Residential Construction		Existing Residential Property		Other Property		Total	
	$ millions	Percent	$ millions	Percent	$ millions	Percent	$ millions	Percent
1959	352	61	95	16	130	23	577	100
1960	378	64	79	13	131	23	588	100
1961	495	67	103	14	140	19	738	100
1962	533	68	118	15	135	17	786	100
1963	616	68	127	14	160	18	903	100
1964	647	64	164	16	200	20	1,011	100
1965	690	60	198	17	269	23	1,157	100
1966	459	57	126	16	219	27	804	100
1967	494	62	135	17	171	21	800	100
1968	614	73	73	9	158	18	845	100
1969	379	61	54	9	189	30	622	100
1970	177	40	38	8	240	52	455	100
1971	353	42	74	8	423	50	850	100
1972	414	40	109	10	519	50	1,042	100
1973	588	40	154	10	729	50	1,471	100
1974	400	34	161	14	611	52	1,172	100

Source: CMHC, *Canadian Housing Statistics*, 1974.

Total NHA and Conventional Mortgage Approvals by Life Insurance Companies, 1958-1974 ($ millions) — Table 12-9

Year	Single Family	Multiple Family	Total
1958	269.5	161.7	431.2
1959	270.9	176.2	450.1
1960	307.7	149.9	457.6
1961	391.5	206.9	598.4
1962	407.3	243.1	650.4
1963	392.4	350.3	742.7
1964	350.9	460.1	811.0
1965	386.5	501.9	888.4
1966	308.2	276.5	584.7
1967	280.2	348.3	628.5
1968	251.4	435.1	686.5
1969	187.3	245.3	432.6
1970	105.4	110.5	215.9
1971	161.6	263.3	424.9
1972	244.7	274.0	518.7
1973	368.6	366.4	735.0
1974	351.7	208.2	559.9

Source: CMHC, *Canadian Housing Statistics*, 1974.

ings offer an opportunity for equity participation which is not available on single family units. Also, because of the higher costs of serviced land, labour, materials, and municipal services, many people can be housed at less cost in apartments than in the traditional single family structure. The major reason for this shift, however, is the fact that mortgages on rental properties typically have a longer term, a characteristic which appeals to insurance companies.

As noted in the previous chapter, chartered banks have tended to prefer single family over multiple family housing mortgages because of the contacts that could be made for other bank services. In the past, insurance companies have, to some extent, made use of their contacts by supplying lists of applicants for single family home mortgages to their life insurance salesmen as possible policy purchasers. However, this source of business does not seem to substantially influence life insurance companies' portfolio activities.

NEW AND EXISTING PROPERTY

Table 12-10 indicates the distribution of new and existing residential mortgage approvals by life insurance companies. The division of insurance company funds between new and existing residential property has remained stable for the last 15 years. The emphasis on new properties reflects the traditionally close relationship between insurance companies and builders.

Mortgages Loans Approved Annually by Life Insurance Companies, 1957-1974 — **Table 12-10**

Year	New Residential Property in $ millions		Existing Residential Property in $ millions		New Residential Property in Percent		Existing Residential Property in Percent	
	Single Family	Multiple Family	Single Family	Multiple Family	Single Family	Multiple Family	Single Family	Multiple Family
1957	164	87	44	13	53.2	28.2	14.3	4.3
1958	213	140	57	22	49.3	32.4	13.2	5.1
1959	204	148	67	28	45.6	33.1	15.0	6.3
1960	244	134	63	16	53.4	29.3	13.8	3.5
1961	317	178	75	29	52.9	29.7	12.5	4.9
1962	324	209	83	34	49.8	32.2	12.8	5.2
1963	309	307	83	44	41.6	41.3	11.2	5.9
1964	252	395	99	65	31.1	48.7	12.2	8.0
1965	251	439	135	63	28.3	49.4	15.2	7.1
1966	207	252	101	24	35.4	43.2	17.3	4.1
1967	181	312	99	36	28.8	49.7	15.8	5.7
1968	199	415	53	20	29.0	60.4	7.7	2.9
1969	146	232	41	13	33.8	53.7	9.5	3.0
1970	79	98	26	13	36.6	45.4	12.0	6.0
1971	112	234	49	24	26.4	56.4	11.6	5.6
1972	178	231	67	43	34.3	44.5	12.9	8.3
1973	271	309	97	57	36.9	42.1	13.2	7.8
1974	240	159	112	50	42.8	28.3	20.0	8.9

Source: CMHC, *Canadian Housing Statistics*, 1974.

Chapter 13

Trust and Mortgage Loan Companies

The objective of this chapter is to discuss the investment activities of trust and mortgage loan companies with particular emphasis on mortgages.

THE BUSINESS OF TRUST COMPANIES

Trust companies are financial intermediaries which invest funds received in the form of deposits, guaranteed investment certificates or in trust from clients. In addition, trust companies provide a number of related services such as safekeeping, acting as an agent, managing estates and providing pension services. In 1973, there were 63 Canadian Trust companies administering assets of almost $40 billion.[1]

Trust companies administer three broad categories of funds including company funds, guaranteed funds and estate, trust and agency funds (E,T & A). *Company funds* are the assets of the trust company which are owned by the shareholders and, as seen in Table 13-1, these are only a small proportion of the funds under administration. *Guaranteed funds* are derived from demand and term deposits. Table 13-2 shows that, in the last two decades, trust companies have allocated an increasingly larger proportion of company and guaranteed funds to mortgages and a smaller proportion to government securities. Trust companies have also begun to make consumer and small business loans.[2] *Estate, trust and agency funds* are those administered by the firm in trust and include the estates of deceased persons, pension funds, and funds created for business purposes.

In addition to the direct investment of funds in mortgages, trust companies are active in other areas of the mortgage market. Many trust companies are affiliated with mortgage loan companies. Most companies also have a real estate sales division which does a substantial volume of business. Royal Trust, for example, had 84 sales offices and 1,200 real estate salesmen in 1973. Some trust companies

1. Trust Company Association of Canada, *General Information Bulletin No. 58,* Toronto, August 1974.

2. See "Trust Company President Foresees Demand for Small Business Loans," *The Globe and Mail,* Toronto, January 3, 1974.

Distribution of the Assets Under Administration Trust Companies Registered in Ontario by Source, 1973 — **Table 13-1**

Source	$ millions	Percent
Company	588	1.57
Guaranteed	8,988	24.00
E, T & A	27,881	74.43
Total	37,457	100.00

Source: *Report of the Registrar of Loan and Trust Corporations, Ontario,* 1973.

have sponsored real estate investment trusts and mortgage investment companies; others are affiliated with mortgage insurance companies. Trust companies originate a large number of mortgages for their own accounts and for clients as well.

THE LEGISLATIVE ENVIRONMENT

Each province has its own trust and loan companies act while federally, there are two relevant acts: The Trust Companies Act and The Loan Companies Act. Almost two-thirds of all trust company assets are held by provincially incorporated firms.[3] The federal Department of Insurance supervises all federally incorporated trust companies and, by special agreement, those incorporated in Manitoba, Nova Scotia and New Brunswick. In order to operate in a particular province, the trust company must register and subscribe to the applicable provincial legislation and regulations. The result is that national trust companies must operate under several, sometimes conflicting, jurisdictions.[4] However, since all of the large trust companies are either federally incorporated or registered in Ontario and, since both federal and Ontario trust company legislation are similar, this matter will be discussed as though all firms are subject to the Ontario legislation.

Trust companies perform almost all of the activities of chartered banks, except for the creation of credit. In addition, they are permitted to act as a trustee for individuals and corporations. The most significant regulations, for our purposes, include restrictions on the amount and nature of the *leverage*[5] employed and on permitted investments.

Trust companies are permitted to accept money in trust, repayment of which is guaranteed; with the exception of subordinated notes, they are not permitted to

3. For more information on the level of federal and provincial trust company activity in Canada, see E.P. Neufeld, *The Financial System of Canada*, Toronto: Macmillan Company of Canada Limited, 1972, pp. 292-304.

4. For a discussion of one of these conflicts, see, for example, "Federal Rules Favored for Financial Institutions," *The Globe and Mail,* Toronto, February 15, 1973.

5. *Leverage*, in this context, refers to the use of borrowed funds in order to increase the rate of return to an equity holder.

The Distribution of Company and Guaranteed Funds of Trust Companies in Percent, 1951-1974

Table 13-2

Year	Cash and Demand Deposits	Government of Canada Securities	Provincial & Municipal Securities	Deposits and Corporation Notes and Bonds	Mortgages and Sales Agreements	Personal & Collateral Loans	Canadian Equities	Other Assets	Total Assets
1951	4.9	30.5	15.0	7.1	28.5	4.6	4.6	4.6	100.0
1952	6.8	27.3	15.4	8.2	28.8	4.4	4.4	4.6	100.0
1953	5.4	26.5	16.0	8.1	31.0	4.0	4.6	4.3	100.0
1954	5.2	26.2	17.5	10.3	28.3	5.2	3.7	3.3	100.0
1955	4.9	21.3	19.3	10.2	32.2	5.1	3.2	3.8	100.0
1956	6.1	17.8	15.5	12.0	36.3	4.6	3.9	3.8	100.0
1957	4.9	17.4	15.2	13.2	35.4	5.4	4.4	4.0	100.0
1958	4.1	18.0	17.1	11.8	36.1	5.9	3.7	3.3	100.0
1959	4.0	17.8	13.9	13.7	38.7	4.8	3.6	3.6	100.0
1960	3.2	20.7	13.2	15.5	36.7	4.2	3.3	4.1	100.0
1961	3.4	18.0	13.4	15.0	39.6	4.0	3.3	3.2	100.0
1962	2.9	15.8	12.1	13.8	44.6	4.4	3.3	3.1	100.0
1963	3.1	13.7	11.5	13.1	47.5	5.3	2.8	3.0	100.0
1964	3.0	13.5	10.7	13.3	50.7	3.6	2.3	3.0	100.0
1965	2.8	11.1	9.2	12.2	56.6	3.1	2.2	2.7	100.0
1966	2.2	11.2	9.1	13.4	55.3	3.1	2.1	3.7	100.0
1967	2.1	10.5	9.1	14.3	55.5	2.6	2.0	3.9	100.0
1968	2.4	10.4	8.1	15.4	54.8	2.9	2.0	4.1	100.0
1969	4.0	10.3	6.6	12.7	56.6	2.8	1.9	5.2	100.0
1970	5.0	8.2	6.3	14.0	58.3	2.6	1.6	3.9	100.0
1971	3.4	7.0	6.5	15.2	60.0	2.5	1.6	3.7	100.0
1972	1.6	6.0	5.3	15.8	63.5	2.9	1.7	3.2	100.0
1973	0.8	4.1	4.1	15.2	68.5	2.6	1.6	3.1	100.0
1974	1.2	3.1	3.4	13.0	71.1	2.9	1.8	3.5	100.0

Source: *Bank of Canada Review*, various issues.

issue bonds or debentures.[6] Mortgage loan companies differ from trust companies in that they are free to issue debentures.

With regard to leverage, trust and loan companies are permitted to borrow (in the case of trust companies, through the use of guaranteed deposits) up to 12 1/2 times the excess of assets over liabilities including subordinated notes; a ratio which may be increased up to 20 times or more if permission is granted by the Lieutenant Governor-in-Council.[7] There has been pressure on the part of some trust companies to increase the maximum borrowing limit in view of close government supervision and a narrowing spread between deposit rates and mortgage lending rates.[8]

Trust and loan companies can place their funds in a broad range of loans and investments, including bonds, debentures, stocks, income producing real estate and mortgages; however, at least 50 percent of the guaranteed funds must be invested in securities authorized by the Trustee Act. The investments authorized by the Act are generally the same as those permitted under The Canadian and British Insurance Companies Act which is discussed in Chapter 12. There is a basket clause which allows trust and loan companies to make investments and loans not authorized, but not specifically prohibited, of up to roughly seven percent of assets.[9] Trust and loan companies registered in Ontario must keep a reserve of 20 percent of aggregate borrowings, payable in less than 100 days in the form of cash, government securities, or demand loans which are fully secured by government securities.

Rules pertaining to real estate and mortgages are of particular interest in this chapter. All real estate investments must be made for the production of income. The maximum investment allowed in any single parcel of real estate may not exceed two percent of the assets of the trust company while total real estate investment may not exceed 10 percent of the assets of the trust company. In addition, the income property must exhibit certain minimum income-producing standards. However, except for the reserve requirements specified earlier and prudent liquidity management, there are no limitations on the proportion of total assets devoted to mortgages. Trust and loan companies may invest in NHA or conventional mortgages although, in the case of high ratio mortgages, the amount in excess of 75 percent of value must be insured.[10]

6. *The Loan and Trust Companies Act*, R.S.O. 1970, c. 254, as am. by S.O. 1974, c. 88, s. 13(1).

7. *The Loan and Trust Companies Act*, R.S.O. 1970, c. 254, as am. by S.O. 1974, c. 88, s. 15.

8. For an expansion of this argument, see "Trust Company Law is Considered Unfair," *The Globe and Mail*, Toronto, May 24, 1973.

9. More specifically, the total must not exceed the larger of 15 percent of the company's unimpaired capital and reserve or some other percentage approved by the registrar and not exceeding seven percent of the sum of all unimpaired capital, reserve, guaranteed investments and deposits. *The Loan and Trust Companies Act*, R.S.O. 1970, c. 254, s. 154(b).

10. Some provinces have not yet passed legislation enabling investment in high ratio mortgages.

Trust companies may accept funds in trust and place them in those securities in which private trustees are permitted to invest. Thus, these investments are subject to The Trustee Act discussed earlier. The Ontario Loan and Trust Corporations Act provides for the creation of common trust funds in which monies belonging to various estates and trusts may be invested. In addition, pooled trust funds may be created if the funds of more than 50 persons are combined for purposes of investment, and the investor can receive a proportionate share on demand. The Lieutenant Governor-in-Council may make regulations concerning these funds in areas such as the filing of trust documents, investment restrictions, reserves, and qualifications of salesmen. In practice, investment constraints on the operation of such trusts come primarily from the trust document filed with the Registrar of trust and loan companies, and those regulations applied by the Ontario or other provincial securities commissions. Since the commissions are concerned with portfolio liquidity, they have limited the proportion of mortgages in the portfolio of a pooled trust or open-ended mutual fund with the exception of funds such as the Royal Trust M Fund whose liquidity is guaranteed by Royal Trust.

COMPANY FUNDS

As shown in Table 13-3, the company funds of trust companies are invested in a wide variety of assets. These funds have many purposes related to the overall operation of the firm. For example, they are used for acquiring an interest in other firms, holding real estate required for premises, and making loans to employees. Some company funds are invested in equities to protect against the erosion of shareholders' purchasing power due to inflation. There are also certain tax advantages in holding stocks rather than fixed income securities in the companies own accounts.

GUARANTEED FUNDS

As seen in Table 13-4, trust companies obtain the bulk of their funds from term deposits maturing in one to five years. The importance of chequable deposits has declined as interest rates have risen and savers have become more yield conscious. There appears to be a shift from less than one year (primarily 90 day) money toward one to five year money. However, trust companies do not solicit funds with a term in excess of five years for, if debentures and deposits are redeemable within a period not exceeding five years, they can be insured by the Canada Deposit Insurance Corporation.

Trust companies can influence the amount of deposits or guaranteed funds that they receive by adjusting the interest rates offered. Firms are hesitant to raise the rate paid on chequable and non-chequable deposits because the increase in cost applies not only to new but also to existing deposits. In addition, the supply of funds does not appear to be sensitive to the saving and chequing deposit interest rate. However, guaranteed investment certificate (GIC) money appears to be rate sensitive.[11]

11. A study by Kevin Clinton, "The Demand for Liabilities of Trust and Mortgage Loan Companies," *Canadian Journal of Economics*, May 1974, concluded that interest rates exert only a weak influence on the demand for savings deposits but that Canada Savings Bond sales had a significant negative impact. He also found that short-term (primarily 90 day) deposits were interest sensitive and close substitutes for chartered bank Certificate of Deposits (CD'S).

Investment of Company Funds By Trust Companies Registered in Ontario, 1973

Table 13-3

	$ millions	Percent
Cash	24.9	4.2
Treasury Bills & Short-Term Deposits	39.6	6.7
Bonds	130.6	22.2
Stocks	148.2	25.2
Collateral Loans	13.1	2.2
Consumer Loans	9.7	1.6
Mortgages & Sale Agreements	29.9	5.1
Real Estate	39.5	6.7
Investments in Subsidiaries	64.2	10.9
Advances to Estates, Trusts & Agencies	13.9	2.4
Other	75.1	12.8
Total	588.7	100.0

Source: *Report of the Registrar of Loan and Trust Corporations, Ontario,* 1973.

Proportion of Company and Guaranteed Funds Derived From Various Sources In Percent, 1966-1974

Table 13-4

	1966	1967	1968	1969	1970	1971	1972	1973	1974
Chequable Deposits	14.2	13.1	11.5	7.6	6.2	6.1	6.2	5.3	4.0
Non Chequable Deposits	13.7	13.6	13.1	15.6	16.3	16.5	16.9	14.2	13.8
Term Deposits and GICs Less than one Year Term*	15.6	14.3	16.0	18.0	14.6	13.4	12.5	11.2	13.6
One-five year term*	44.8	47.3	47.4	47.7	52.2	54.6	55.0	60.7	59.6
Over five year term*	0.8	0.7	0.6	0.3	0.4	0.3	0.3	0.3	0.5
Shareholders' Equity	8.5	8.1	7.8	7.2	6.7	6.4	6.3	5.5	5.2
Other	2.4	2.9	3.6	3.6	3.6	2.7	2.8	2.8	3.3
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

* Term equals original term to maturity.

Source: *Bank of Canada Review,* 1974.

Periodically published surveys show the wide variety of rates paid by trust and mortgage companies for deposits. Some results of one such survey are reproduced in Table 13-5. At the time of this survey, the interest rate paid on chequable savings accounts varied from three percent to five percent, with the average being close to four percent. A number of trust companies do not pay any interest on chequable savings accounts but, at the same time, demand no service charge on cheques. On non-chequable savings accounts, the interest rate paid by trust companies varied from 7 1/4 percent to nine percent, although 8 3/4 percent was the usual rate paid. Trust and mortgage companies solicit term deposits that mature in 30 days to five years. Deposits maturing in less than one year are available in minimum amounts which vary from \$500 to \$25,000 – \$5,000 being the usual amount. Many firms are willing to negotiate the rate for deposits of over \$100,000, and a number of yields are available on those GIC's which mature within one to five years even though the minimum investment is frequently set at \$500.

The term structure of interest rates offered depends on the supply of and demand for funds as well as the expectations of the trust companies; thus, rate structures can change drastically in relatively short periods of time. For example, in August 1973, National Trust paid 7 1/4 percent for 30 to 59 day deposits and a gradually increasing rate for longer maturities, reaching a high of 8 3/4 percent for five year GIC's. A July 1974 survey revealed that rates in general had risen although, as Table 13-5 shows, short-term deposits yielded a higher rate than five year deposits. This term structure presumably reflected the feeling that interest rates were expected to decline as, in fact, they did in late 1974 and early 1975.

The most noticeable feature of Table 13-5 is that the saver can increase his return by shopping around among trust companies for better rates. The smaller trust companies commonly pay slightly higher interest rates than the larger firms in spite of the fact that trust company deposits of up to \$20,000 per depositer are insured by the Canada Deposit Insurance Corporation. This disparity in rates by size of firm may be attributed to a number of factors. The small firms tend to have a less extensive branch network and may have to offer a higher yield in order to attract customers to their branches. Other potential customers may be attracted to the prestigious large firms because they do not understand, or are unaware of, deposit insurance. Finally, even if customers are aware of deposit insurance, they may prefer to deal with larger long established companies.

The interest rate that trust companies have to pay for their GIC's depends, to an extent, on competitive pressure from chartered banks. This pressure is felt through competition with bank savings deposits, certificates of deposit and term notes as well as the obligations issued by bank affiliates. Discussions with chartered banks and an informal survey indicate that banks do not usually pay rates for CD's that are as high as those offered by trust companies, although some bank affiliates, such as Kinross and Central Covenants, are competitive. The lower interest rate on bank CD's is partly explained by their more attractive call feature. Banks generally allow their depositors to withdraw term deposits before maturity at a relatively low penalty, one-quarter to one-half percent sacrifice in

interest yield, whereas trust companies will not redeem their GIC's before maturity except in the event of the death of the holder. The impact of tightened monetary policy tends to be felt almost immediately by the chartered banks. When banks become pressed for funds, they bid up the price on deposits of all kinds forcing interest rates to rise. There is a lag between the impact of monetary policy on banks and a measurable impact on trust companies.

Rates Paid on Deposits and Guaranteed Investment Certificates, Selected Trust and Mortgage Loan Companies, July 1974 — **Table 13-5**

	Maturity in Days				
	30-59	60-89	90-179	180-269	270-364
Canada Trust	10.50	10.50	9.75	9.25	9.25
Credit Foncier	10.38	10.50	10.25	10.00	9.75
Guaranty Trust	10.45	10.55	10.30	10.05	9.80
National Trust	10.25	10.25	9.75	9.50	9.50
Royal Trust	10.38	10.50	10.25	10.00	9.75
	Maturity in Years				
	1	2	3	4	5
Canada Trust	10.00	9.75	9.75	9.75	10.00
Credit Foncier	10.13	10.13	10.13	10.13	10.13
Guaranty Trust	10.00	9.25	9.25	9.25	10.00
National Trust	10.00	9.50	9.50	9.50	9.75
Royal Trust	9.50	9.00	9.00	9.00	10.00

Source: *The Globe and Mail*, Toronto, July 9, 1974.

Some trust companies have recently purchased interests in banks in order to increase the scope of their operations. Canada Permanent Trust Co. acquired a 10 percent interest in the Montreal City and District Savings Bank while Metropolitan Trust Company purchased just under 10 percent of the shares of the Bank of British Columbia.[12] Under the Bank Act an investor cannot own over 10 percent of the shares of a bank.[13]

The overall profit of a trust company depends on the services that trust companies provide for clients and, in the case of quaranteed funds, on their ability to maintain a profitable spread between the cost of funds and the rate at which they are invested. Table 13-6 shows that trust companies are investing an increasing proportion of their funds in mortgages at the expense of investments in bonds.

12. For additional details, see "Canada Permanent Buys Share of Bank," *The Globe and Mail*, Toronto, November 23, 1974 and "Metro Trust Buys Shares of B.C. Bank," *The Globe and Mail*, Toronto, March 22, 1975.

13. *Bank Act*, R.S.C. 1970, c. B-1, s. 53(2).

This increased mortgage lending may be attributed to several factors: the increased demand for mortgage funds; the higher yield associated with mortgages; improvements in the insured lending provisions of the NHA, such as the eligibility of five year term mortgages for insurance and removal of the interest rate ceiling; and the introduction of private mortgage insurance. A number of firms were asked to speculate on the practical maximum proportion of assets that could be devoted to mortgages. Most firms indicated that, while this maximum depends on the maturity structure of assets and liabilities, the proportion could be increased up to 80 or even 85 percent of assets.

Investment of Guaranteed Funds by Trust Companies Registered in Ontario in Percent, 1965-1973 **Table 13-6**

	1965	1966	1967	1968	1969	1970	1971	1972	1973
Mortgages and Agreements for Sale	59.9	59.4	60.2	59.1	60.9	63.1	65.1	68.1	72.8
Collateral Loans	3.0	2.6	2.3	2.7	2.6	2.3	2.2	2.4	2.4
Bonds	33.5	31.9	31.0	32.1	28.9	25.2	24.0	19.9	14.3
Stocks	0.2	0.1	0.2	0.1	0.4	—	—	—	0.1
Cash, Treasury Bills and Bank Term Deposits	2.4	5.0	5.4	4.8	5.9	7.9	7.2	8.1	8.5
Other Assets	1.0	1.0	0.9	1.2	1.3	1.5	1.5	1.5	1.9
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: *Report of the Registrar of Loan and Trust Corporations, Ontario,* 1970 and 1973.

It is commonly accepted that the spread between the borrowing and lending rates of trust companies must be greater than 1 1/2 percent in order to provide a satisfactory level of profit. A comparison of the GIC rate and the conventional mortgage rate over the last decade, as shown in Table 13-7, reveals that the spread has varied from 1.3 percent to 2.1 percent. Rapidly rising interest rates from 1972 through 1974 resulted in a spread which was historically quite narrow.

In addition to ensuring that operations are profitable, trust companies are faced with a liquidity management problem. If the term of assets and the term of liabilities were the same, there would be no concern with liquidity except in cases where defaults occurred making assets inadequate to meet liabilities. However, defaults have not been a major problem as their number has been small, and loan to value ratios are normally such that the trust companies can recover their funds if a default occurs.[14] If, however, the term structures of assets and liabilities are different, problems could arise. Trust companies take in some deposits that are repayable on demand and others that have a short term. Suppose these funds

14. For example, as of the end of 1973, the ratio of current loan amount to the value of the property when the mortgage was issued was 56 percent for Credit Foncier.

were invested in 20 year bonds with a yield of 10 percent and the rate paid for short-term money was 8 1/2 percent. If short-term interest rates rose above 8 1/2 percent, the firm would still be investing its funds at 10 percent but would be paying perhaps 9 1/2 percent for money. This would be unprofitable for the firm, given the administrative costs, and may result in its illiquidity should the amount of savings available decrease. The trust industry has responded to this potential problem by increasing liquidity and expanding the portfolio of five year loans matched against five year deposits.[15]

Spread Between Five Year GIC Rates Paid by Trust Companies and Conventional Mortgage Rates, 1964-1974

Table 13-7

		GIC Rate (%)	Conventional Mortgage Rate (%)	Spread (%)
1964	June	5.29	6.88	1.59
	December	5.33	7.00	1.67
1965	June	5.50	6.83	1.33
	December	5.97	7.40	1.43
1966	June	5.97	7.57	1.60
	December	6.22	7.95	1.73
1967	June	6.15	7.88	1.73
	December	6.64	8.52	1.88
1968	June	7.06	9.18	2.12
	December	7.19	9.10	1.91
1969	June	8.00	9.69	1.69
	December	8.58	10.50	1.92
1970	June	8.54	10.53	1.99
	December	8.21	10.16	1.95
1971	June	7.64	9.34	1.70
	December	7.14	9.10	1.96
1972	June	7.95	9.37	1.42
	December	7.57	9.22	1.65
1973	June	8.15	9.52	1.37
	December	8.61	10.02	1.41
1974	June	9.96	11.37	1.41
	December	10.04	11.88	1.84

Source: *Bank of Canada Review,* Various issues.

15. See "Montreal Trust Liquid Assets High," *The Globe and Mail,* Toronto, March 15, 1974 and "Special Report on Trust Companies," *Journal of the Board of Trade of Metropolitan Toronto,* September 1973.

Table 13-8 illustrates the term structure of the consolidated assets and liabilities of Equitable Trust Company and Fidelity Mortgage and Savings Corporation. It shows that short-term liabilities substantially exceed short-term assets, but the bulk of short-term liabilities are deposits whose level can be assumed to be quite stable.

Consolidated Balance Sheet of Equitable Trust Company And Fidelity Mortgage and Savings Corporation by Maturity of Assets and Liabilities as of December 31, 1973

Table 13-8

	Maturity Date					
	1974	1975	1976	1977	1978	Other
Assets						
Cash & Demand deposits	$ 3,956	$ —	$ —	$ —	$ —	$ —
Government of Canada Bonds	25	120	—	355	—	295
Provincial Bonds	—	—	—	—	—	324
Municipal Bonds	5	6	31	—	—	14
Corporate Bonds	—	—	—	—	—	399
Short-Term Notes	2,663	—	—	—	—	—
Demand Loans	3,002	—	—	—	—	—
Mortgages	5,402	7,250	9,004	10,741	20,681	2,925
Other Assets	31	—	—	—	—	889
Total	$15,084	$ 7,376	$ 9,035	$11,096	$20,681	$4,846
Liabilities & Equity						
Demand Deposits	15,462	—	—	—	—	—
Deposit Receipts	4,265	—	—	—	—	—
Debentures & GIC's	7,451	4,745	8,864	9,134	12,602	15
Other Liabilities	1,769	—	—	—	—	393
Owners Equity	—	—	—	—	—	3,417
Total	$28,947	$ 4,745	$ 8,864	$ 9,134	$12,602	$ 3,825

Source: Equitable Trust Company and Mortgage and Savings Corporations, *Annual Reports,* 1973.

Guaranty Trust provides an example of the problems of maturity balancing. As of May 1974, the firm held $170 million in long-term NHA mortgages yielding 6 3/4 percent. At the same time, rapidly increasing interest rates pushed the cost of GIC money to over 10 percent. Although one solution would have been to raise equity, declining earnings and a possible need to decrease dividends made the stock relatively unattractive. A number of remedies have been proposed by management which include increasing total assets, encouraging low interest rate mortgage holders to refinance, and diversifying the lending portfolio.[16]

ESTATE, TRUST AND AGENCY ACCOUNTS

Trust companies are empowered to act as agents for individuals and corporations and may take legal title and possession of property as a trustee for a beneficiary. The Trust Companies Association has proposed six broad classifications for the many types of trust arrangements in Canada.[17]

- *Testamentary Trusts* are trusts set up to manage the assets of an estate. It is unlikely that such a trust would be set up for an estate valued at less than $50,000.
- *Intra-Company Trusts* are common or pooled funds set up within a trust company. Small personal or testamentary trusts are grouped together through the purchase of trust "units" for portfolio management purposes.
- *Personal Trusts* are set up for such purposes as marriage settlement or infant protection.
- *Personal Business Purpose Trusts* include buy-sell agreements, stock purchase trusts and business sale trusts.
- *Business Trusts Having Personal Purposes* are trusts formed for the benefit of individuals and include pension fund trusts, profit sharing trusts and registered retirement savings plans.
- *Business Trusts* include investment fund trusts, stock escrow trusts, etc. The investment fund trusts are usually sold in the form of redeemable "units" available at trust company offices.

Table 13-9 illustrates the different E,T & A account investment policies of the five largest Ontario registered trust companies at the end of 1973. Montreal Trust, for example, has the highest proportion in mortgages and bonds and the lowest proportion in stocks of those firms illustrated. The investment differences between trust companies are attributable to the nature of the accounts being

16. For a further discussion, see "Guaranty's Problems will Take Time to Work Out," *The Financial Post*, Toronto, May 25, 1974 and "Guaranty Payout Decision," *The Globe and Mail*, Toronto, May 22, 1974.

17. See *Submission on the Proposals Contained in the White Paper on Taxation*, Toronto: Trust Companies Association of Canada, submitted to the Standing Committee on Banking, Trade and Commerce of the Senate of Canada, May 1970.

administered and, in some cases, to the preferences of the individual trust managers. Royal Trust accounts for almost 40 percent of all E,T& A assets, although the importance of E,T& A business also varies between trust companies. For example, in 1973 E,T & A accounts represented 73 percent of all assets administered by National Trust while they represented only 10 percent for the much smaller Premier Trust Company.

Dollar Size and Percentage Distribution of The Investment of E,T& A Accounts for the Five Largest Trust Companies Registered in Ontario, 1973* **Table 13-9**

	Royal	Montreal	National	Canada	Canada Permanent
Dollar Size of E,T & A Business ($ billions)	$ 10.94	$ 5.28	$ 2.44	$ 2.38	$ 2.32
Percent Distribution of E,T & A Assets					
Cash	1.7	0.7	2.0	—	1.2
Bonds	30.5	52.9	34.1	32.4	38.9
Stocks	52.1	21.3	50.7	48.1	46.3
Mortgages	10.8	17.0	8.8	7.5	6.1
Deposit in Guaranteed Funds	1.3	2.3	1.5	5.2	0.9
Deposit in Associated Companies	—	—	—	2.3	3.0
Real Estate	1.0	1.9	1.4	1.5	2.1
Other	2.6	3.9	1.5	3.0	1.5
Total	100.0	100.0	100.0	100.0	100.0

* Ranked by dollar size of E,T & A business.

Source: *Report of the Registrar of Loan and Trust Corporations, Ontario,* 1973.

Estates can vary in size from $5,000 up to $5 million or larger, and even though it is difficult to generalize, the average size is about $150,000. When a testamentary trust is set up, a wide variety of investment restrictions are possible. However, it has become more usual to restrict investments to the kinds, but not the proportions, specified under The Canadian and British Insurance Companies Act. If no restrictions are specified, the guidelines provided by provincial trustee acts normally apply; these acts normally permit mortgage investments. Within these broad restrictions and any other specific constraints applied by the will, the trustee has a fairly wide degree of latitude. The trust company itself will often provide a list of investments from which the individual trustee is expected to choose. Mortgages are normally permitted as investments but this does not ensure that they will become part of the portfolio.

A number of factors determine the presence or absence of mortgages in a trusteed account. If the account is quite small, less than $75,000, investment in mortgages tends to make the account less flexible because mortgages are large in comparison to the size of the account. Mortgages are attractive if the account needs a high quality current income, although, if the client is in a high tax bracket or looking for long-term capital gains, the purchase of low-coupon high-discount bonds or common shares may be more appropriate. Mortgages are avoided when distribution of the assets is possible in the near term. When an estate is divided and paid to beneficiaries, it is common practice to split the assets of the account rather than convert all assets into cash; bonds or shares are easier to distribute in this way than are mortgages. Of course, the attitude of the beneficiaries towards mortgages is an important determining factor in whether mortgages will be part of the trusteed account. Large estates with distribution dates well into the future, pension funds and pooled investments may all be invested in mortgages.

The fund management activities of trust companies warrant further discussion. Trust companies will, in return for a fee, manage funds for individuals and will also provide advice, look after transactions and perform custodial services. If the investment is very large or if specific instructions have been given, the trust company may manage the account individually, but if it is relatively small, the company will usually purchase units in one of its managed funds. A *managed fund* is like an open-ended mutual fund in that investors purchase units the value of which is determined by dividing the market value of the portfolio by the number of units outstanding. These fund units are sold through trust company branches and do not normally involve a loading charge although an administration fee is charged. Managed funds are created under provincial legislation by a declaration of trust which outlines the investment and management policies of the trust. Many of these managed funds have specific investment policies which allow their units to qualify as a registered retirement savings plan investment.

Royal Trust provides an example of trust company managed funds.[18] It has four managed funds called A, B, C, and M. The A-Fund is invested in common shares, preferred shares and convertible debt, all of foreign corporations. The B-Fund is invested in bonds, debentures, first mortgages, or preferred shares. The C-Fund is invested in Canadian preferred and common shares and convertible debt. The M-Fund is invested exclusively in first mortgages on Canadian properties.

The managed funds specializing in mortgages have met with approval from the small investors in the market place. Since these funds do not have to be incorporated, the only real legislative constraints that they face are to keep within their original investment objectives and to meet any regulations established by the securities commissions in the provinces in which they sell. The Ontario Securities Commission requires the sponsors of these funds to stand ready to purchase any mortgages necessary to provide the fund with liquidity. As a result the M-Fund,

18. For a detailed discussion of investment funds, see *The Financial Post Survey of Funds - 1973*, Toronto: MacLean Hunter Limited.

for example, would not be allowed to grow larger than Royal Trust's ability to buy mortgages on short notice from the fund.[19] It is interesting to note that if a large secondary market in mortgages was ever developed, or if a government institution which stood ready to buy mortgages was developed, funds like the Royal Trust M-Fund and the Metropolitan Trust mortgage income fund might be able to expand faster and grow larger.

In an effort to encourage home ownership, The Income Tax Act was revised in 1975 to provide for *Registered Home Ownership Savings Plans* (RHOSP's) which may indirectly be invested in mortgages. If an individual is at least 18 years old and has not owned property in the taxation year, he can contribute up to $1,000 per year with a lifetime maximum of $10,000 to a RHOSP. The contributions made and all income or capital gains earned escape tax completely as long as the funds are used to purchase housing or eligible furnishings, although all money must be withdrawn from the plan at once. If the funds are not used for a house purchase they may be rolled over into a Registered Retirement Savings Plan (RRSP) tax free. An individual may only have one RHOSP in his lifetime and a husband and wife may each have a plan. Once a plan has been created it may not be transferred between financial institutions. Each plan must be registered and administered by a trustee which means that trust companies must act as trustees for other financial institutions that wish to have a plan. The members of the Trust Companies Association of Canada initially resisted acting as trustees for other institutions because they felt that the inspection requirements could not be properly carried out. However, other financial institutions were able to get individual trust companies to act for them; for example, Morguard Trust, a firm which did not accept deposits and was not a member of the Trust Companies Association, became the trustee for Canada's five largest chartered banks. This skirmish between trust companies and banks has at least two implications for the mortgage market. First, the way in which the funds are ultimately invested depends upon the normal investment activities of the sponsoring institution, as discussed in this and other chapters. Most institutions initially offered a guaranteed savings plan, but some have suggested that other plans based on mortgages or equities would be marketed in the future. Second, the institution managing the investments may have a better chance of originating the mortgage loan. Some firms deduct administration, registration and termination fees but some such as Victoria and Grey Trust Company waive the withdrawal fee if the investor uses the mortgage facilities of the firm to purchase a house.

THE FLOW OF MORTGAGE FUNDS

Trust companies determine in September or October what their mortgage requirements will be for the coming year. This is accomplished by estimating the levels of guaranteed deposits and originations for estate, trust and agency clients. However, the inflow of funds is uneven — for example, one firm felt that it was

19. Royal Trust has guaranteed that, if withdrawals exceed available cash and marketable securities, they will find a purchaser for all mortgages to be sold. The price will not be less than 95 percent of the value of the mortgages.

easier to sell guaranteed investment certificates in the late fall or first quarter of the year. Registered retirement savings plan funds flow more heavily in February since any contributions made by the end of February qualify as tax deductible for the preceding tax year. Although the collection of realty taxes from borrowers occurs throughout the year, tax payments to the municipality usually occur twice a year.

After mortgage requirements are estimated the organization prepares a plan to originate mortgages at a rate sufficient to meet demand. The heaviest period for commitment of mortgage funds is from February through to May largely because building starts are heavier in the spring. During this period, the trust companies arrange to place funds with builders and other clients. Business is somewhat slower in the summer as actual cash begins to go out. In the period September to December the available supply of mortgage funds tends to become tighter as trust companies have already allocated their yearly funds. However, the rate of origination of mortgages can be varied by the trust company by manipulation of the interest rate they charge, the commission on mortgages found and the stringency with which loan to value ratios are computed and applied.

ALLOCATION OF MORTGAGE FUNDS

Trust companies prefer to direct their funds into areas where good quality building is taking place and where they have local offices. Diversification of the mortgage portfolio by type of mortgage and geographical area is also a factor. Sometimes a company will decrease its activities in a certain area because it is being over built or because the houses are considered to be over-valued. Small trust companies concentrate on their own local area but the larger firms allocate funds on a national basis using such criteria as population levels, state of the local economy and the level of savings derived from that area.[20] An example of the geographical distribution of mortgage loans is provided by Credit Foncier. As of 1973, the firm had 20 percent of its loans in British Columbia, 18 percent in the Prairie provinces, 26 percent in Ontario, and 36 percent in Quebec. This Quebec based firm has begun to open branches in the Maritimes.[21] When the supply of funds becomes very tight, trust companies either decrease loan to value ratios, or increase mortgage interest rates or cease accepting applications.[22] Under these conditions, some firms have placed quotas on each branch; others have given preference to purchasers of houses through the trust company's real estate division.[23]

20. For example, Mr. A.H. Mingay, the newly appointed president of Canada Trust was quoted as saying "...the company's mortgage portfolio in Quebec is larger than the amount of savings deposits and the company is looking for ways to expand deposits." See "Federal Rules Favored for Financial Institutions," *The Globe and Mail,* Toronto, February 15, 1973.

21. See Credit Foncier, *Annual Report,* 1973.

22. See "Loans are Limited to 75 Percent," *The Globe and Mail,* Toronto, May 17, 1974.

23. See "Small Real Estate Dealers Hurt, Others have Financing Priority," *The Globe and Mail,* Toronto, May 21, 1974.

TYPES OF MORTGAGES ORIGINATED BY TRUST COMPANIES

Tables 13-10 and 13-11 point out a number of characteristics of trust company mortgage loans. Trust companies expanded their mortgage lending from 1959 to 1965, a period during which banks were essentially out of the mortgage market. This, coupled with the fact that banks paid a relatively low rate of interest on deposits, led to the formation of a number of new trust companies in Ontario in the period 1963-1965 which resulted in strong rate competition between trust companies. Some of these companies invested their short-term funds in long-term mortgages and, subsequently, were unable to refinance their maturing short-term liabilities at the same low rates of interest. The illiquidity of several of the smaller trust companies along with the Atlantic Acceptance failure led to the consolidation of several companies and the formation of the Canada Deposit Insurance Corporation (CDIC) which, for a fee, insures deposits of up to $20,000 for any one lender. CDIC is also able to act as a lender of last resort in the event that a liquidity problem occurs. After the setback to the trust industry in 1965 and 1966 the trust companies again began to expand their operations and to steadily increase mortgage originations. Even though there was a severe credit crunch in 1970 which forced all financial institutions to cut back their mortgage lending, this was short-lived, and after 1970 there was a rapid growth in mortgage loans culminating in a large surge in 1973. In 1974, the rate of growth of trust company deposits slowed and mortgage loan approvals, while still substantial, dropped below 1973 levels.

As Table 13-10 suggests, trust companies have typically loaned the bulk of their funds for conventional mortgages on existing property. NHA mortgages, as a proportion of total loans, have been declining gradually, particularly in 1973 and 1974 when the maximum loan permitted under NHA became inadequate for a large proportion of new home buyers.

As Table 13-11 illustrates, in the last 15 years trust companies have devoted between 60 and 70 per cent of their mortgage funds to single family housing. The remaining 30 to 40 percent allocated to multiple family dwellings is proportionately much higher than the amount invested in the same type of dwelling by chartered banks. The fact that trust companies have had greater experience with multiple dwelling loans, coupled with the preference chartered banks give towards single family loans — to attract customers for their other services — may account for the difference. However, as trust companies begin to offer the same services as banks, and banks become more experienced in multiple family loans, the proportions of the various types of mortgages originated by these two institutions may become more similar. The drop off in multiple family lending by trust companies in 1974 is probably a temporary phenomenon related to the severe decline in that type of construction in 1974.

Mortgage Loans Approved on New and Existing Residential Property by Trust Companies, 1959-1974

Table 13-10

	New Residential Property				Existing Residential Property				
	NHA		Conventional		NHA		Conventional		Total
	$ millions	Percent	$ millions	Percent	$ millions	Percent	$ millions	Percent	$ millions
1959	11.9	10	52.5	44	—	—	55.4	46	119.8
1960	56.7	39	31.2	21	—	—	58.0	30	145.9
1961	175.3	64	15.0	5	—	—	85.5	31	275.8
1962	147.5	48	51.2	17	—	—	106.3	35	305.0
1963	145.3	36	104.3	26	—	—	155.6	38	405.2
1964	171.2	33	101.8	20	—	—	242.8	47	515.8
1965	194.3	32	121.4	20	—	—	295.6	48	611.3
1966	101.7	30	42.4	13	—	—	191.2	57	335.3
1967	161.7	29	140.8	25	—	—	250.6	46	553.1
1968	238.8	30	289.4	37	—	—	256.1	33	784.3
1969	236.4	24	413.9	41	3.5	—	350.7	35	1004.5
1970	299.5	34	245.0	27	25.1	3	321.9	36	891.5
1971	429.6	32	312.4	23	59.2	4	552.5	41	1354.0
1972	481.3	29	426.2	26	92.8	6	651.3	39	1651.6
1973	520.0	19	723.8	26	122.8	5	1382.0	50	2748.8
1974	244.6	11	623.0	29	113.9	5	1169.9	54	2151.4

Source: CMHC, *Canadian Housing Statistics, 1974.*

NHA and Conventional Mortgage Loans Approved by Trust Companies, By Type of Dwelling and Nvw Versus Existing Property, 1959-1974

Table 13-11

	New Residential Property				Existing Residential Property				
	Single Detached		Multiple Dwelling		Single Detached		Multiple Dwelling		Total
	$ millions	Percent	$ millions	Percent	$ millions	Percent	$ millions	Percent	$ millions
1959	34.3	30	30.1	25	45.6	38	9.7	7	119.7
1960	60.6	42	27.3	19	49.9	34	8.1	5	145.9
1961	128.1	47	62.1	23	70.3	25	15.2	5	275.7
1962	123.7	41	75.1	25	89.7	29	16.6	5	305.1
1963	141.2	35	108.4	27	127.8	32	27.9	6	405.3
1964	118.3	23	154.7	30	196.6	38	46.3	9	515.9
1965	141.0	23	174.7	29	232.6	38	63.0	10	611.3
1966	73.1	22	71.0	21	162.8	49	28.4	8	335.1
1967	92.1	17	210.4	38	219.4	40	31.2	5	553.1
1968	187.7	24	340.5	43	215.6	27	40.5	6	784.3
1969	315.0	31	335.3	34	302.3	30	51.9	5	1004.5
1970	239.1	27	295.4	34	297.9	34	49.1	5	881.5
1971	319.8	24	406.1	30	534.1	40	77.6	6	1337.6
1972	415.4	25	470.5	29	661.3	41	82.8	5	1630.0
1973	625.0	23	600.2	22	1323.0	48	182.0	7	2730.2
1974	556.0	26	297.1	14	1119.2	52	164.5	8	2136.8

Source: CMHC, *Canadian Housing Statistics*, 1974.

MORTGAGE LOAN COMPANIES

Mortgage loan companies differ from trust companies in two major ways. First, they are not permitted to act as trustees and agents and second, mortgage loan companies issue debentures rather than guaranteed investment certificates. Many of the mortgage loan companies either own or are owned by trust companies. For example, Canada Permanent Mortgage Corporation owns Canada Trust. In addition, several of the chartered banks own captive mortgage corporations.

Table 13-12 illustrates that mortgage loan companies obtain funds from deposits and debentures and invest them primarily in mortgages. The proportion of assets invested in bonds and stocks has steadily declined, while the proportion of assets devoted to mortgages and other investments has increased. Table 13-13 shows that, while mortgage companies place a large proportion of their assets in mortgages, the proportion may vary significantly between firms.

Within the mortgage portfolio, the proportion of assets devoted to conventional mortgage loans represents a large proportion of approvals as shown in Table 13-14. Loan companies began to make NHA loans on existing property following legislative changes in 1969. In total, the proportion of assets devoted to existing, versus new, residential property mortgages has remained quite stable over time at close to 50 percent. Table 13-15 presents the breakdown of mortgages between single detached and multiple dwellings for mortgage loan companies and a number of other lenders.

Assets and Liabilities of Loan Companies, Selected Years						Table 13-12
	1964		1969		1974	
	$ millions	Percent	$ millions	Percent	$ millions	Percent
Assets						
Cash and Short Term Assets	74	3.8	66	2.0	288	4.3
Government of Canada Bonds	117	6.0	123	3.7	84	1.2
Provincial and Municipal Bonds	53	2.7	60	1.8	59	0.9
Corporate Bonds	26	1.3	33	1.0	71	1.1
NHA Mortgages	1,492	77.0	210	6.4	688	10.2
Conventional Mtgs.			2,298	69.8	4,822	71.5
Canadian Shares	56	2.9	73	2.2	88	1.3
Personal and Collateral Loans	13	0.7	28	0.9	112	1.7
All Other	105	5.6	400	12.2	531	7.8
Total	1,936	100.0	3,291	100.0	6,743	100.0
Liabilities & Equity						
Demand & Savings Deposits	321	16.6	441	13.4	660	9.8
Term Deposits & Debentures Less Than						
1 Year Term*	N/A	N/A	46	1.4	188	2.8
1-5 Year Term*	N/A	N/A	1,295	39.3	3,453	51.2
Over 5 Year Term*	N/A	N/A	615	18.7	492	7.3
Notes	108	5.6	111	3.4	360	5.3
Debentures	—	—	—	—	562	8.3
Other Liabilities	71	3.7	356	10.8	461	6.8
Shareholders Equity	254	13.1	427	13.0	567	8.4
Total	1,936	100.0	3,291	100.0	6,743	100.0

* Term = original term to maturity.

Source: *Bank of Canada Review,* various issues.

Assets of Selected Loan Companies, (At Book Value), 1963 and 1973

Table 13-13

Company	Year	Total Assets $ millions	Assets in Percent			
			Bonds	Stocks	Mortgages	Other
Canada Permanent Mortgage	1963	374.6	14.3	6.8	72.5	6.4
	1973	1,038.1	8.2	2.6	77.5	11.7
Eastern Canada Savings	1963	75.3	6.5	0.9	89.8	2.8
	1973	314.4	3.3	0.6	92.7	3.4
Huron and Erie Mortgage	1963	275.3	14.1	4.1	76.7	5.1
	1973	950.7	6.2	1.0	75.8	17.0
Kinross Mortgage	1963	6.9	—	—	97.1	2.9
	1973	436.6	—	—	96.8	3.2
Nova Scotia Savings & Loan	1963	25.2	4.4	0.9	93.7	1.0
	1973	208.7	1.0	0.2	91.4	7.4

Source: *Report of the Superintendent of Insurance for Canada, Loan and Trust Companies*, 1963 and 1973.

NHA and Conventional Mortgage Loans Approved on New and Existing Residential Property by Loan Companies, 1959-1974

Table 13-14

	New Residential Property				Existing Residential Property			
	NHA		Conventional		NHA		Conventional	
Year	$ million	Percent	$ million	Percent	$ million	Percent	$ million	Percent
1959	6.8	6	46.0	42	—	—	56.9	52
1960	5.0	3	67.9	48	—	—	70.1	49
1961	19.9	12	62.4	36	—	—	88.7	52
1962	28.9	13	77.8	36	—	—	108.6	51
1963	21.2	8	130.2	47	—	—	122.8	45
1964	9.1	2	184.1	48	—	—	189.3	50
1965	6.0	2	150.3	41	—	—	210.7	57
1966	4.0	2	116.2	46	—	—	132.5	52
1967	6.1	2	131.1	46	—	—	150.7	52
1968	55.6	16	166.1	47	—	—	131.6	37
1969	66.7	16	200.8	48	5.9	1	147.0	35
1970	84.6	22	115.5	30	48.9	13	136.5	35
1971	245.7	31	156.2	20	130.3	17	254.5	32
1972	238.1	22	290.2	27	138.8	13	388.7	38
1973	123.3	11	432.7	39	111.0	10	455.7	40
1974	66.7	5	480.7	40	170.0	14	493.5	41

Source: CMHC, *Canadian Housing Statistics,* various issues.

Single and Multiple Dwelling Mortgage Loans Approved on New and Existing Residential Property by Loan and Other Companies,* 1959-1974

Table 13-15

	New Residential Property				Existing Residential Property			
	Single Detached		Multiple Dwelling		Single Detached		Multiple Dwelling	
Year	$ millions	Percent	$ millions	Percent	$ millions	Percent	$ millions	Percent
1959	32.0	26	27.2	22	45.0	35	20.8	17
1960	45.0	27	36.5	22	53.0	32	30.9	19
1961	50.5	24	49.7	23	70.0	33	41.3	20
1962	56.1	21	74.9	28	83.5	31	50.6	20
1963	79.3	25	92.3	29	93.8	29	54.1	17
1964	101.6	21	133.9	29	148.6	32	84.2	18
1965	91.2	20	118.9	26	172.0	36	83.3	18
1966	80.8	26	81.6	26	109.1	34	44.7	14
1967	73.0	21	104.2	30	126.5	37	41.3	12
1968	127.6	27	192.6	41	106.2	23	40.2	9
1969	163.1	29	213.8	38	126.9	23	56.2	10
1970	121.3	24	166.3	32	151.9	30	71.4	14
1971	228.8	24	285.9	31	324.5	35	96.1	10
1972	362.1	29	292.7	24	456.7	37	124.1	10
1973	407.3	32	244.9	19	477.8	37	156.1	12
1974	446.3	33	159.3	12	560.7	42	169.5	13

* Includes Quebec savings banks, mutual benefit and fraternal societies.

Source: CMHC, *Canadian Housing Statistics,* 1974.

Chapter 14

Pension Funds

The objective of this chapter is to give an overview of Canadian pension plans as well as a detailed discussion of their mortgage investment practices.

NATURE OF PENSION PLANS[1]

A pension plan is an arrangement whereby a person or firm provides for future benefits through a specific funding program. The plan usually specifies who is eligible, the benefits to be received and when the benefits will be received. The funding program may involve paying the liability as it occurs or setting aside specific funds to meet the future liability. The former method is usually referred to as *pay-as-you-go funding* while the latter may be referred to as *advance funding*. For our purposes we will use the terms "funded" and "advance funded" interchangeably unless otherwise indicated. Many government related plans are non-funded while most other plans are funded.[2]

Pension contributions are made by the employer, the employee or both. The amount of funds set aside depends on the desired future benefits, the timing of benefit payments, the mortality rate of plan participants and the rate of return earned on the invested funds. A pension plan may be fully insured or self-administered. Under a fully insured plan, the plan administrator purchases a future annuity from an insurance company which guarantees the return earned and takes the mortality risk. Under a self-administered plan, funds are set aside with a trustee, trust company or insurance company which, in the judgment of an actuary, will be adequate to meet the future liability. The employer retains all or part of the yield and mortality risks as he takes on the responsibility of ensuring the prescribed benefits will be available to members of the pension plan for life. At regular intervals, the present value of the anticipated liabilities of the pension plan is actuarially determined. When the liabilities exceed the value, the difference must be made up either in the current year or over a series of years.

1. For an excellent discussion of Canadian pension plans, see Lawrence E. Coward, *Canadian Handbook of Pension and Welfare Plans*, Toronto: CCH Canadian Limited, 1974.

2. The issue of whether all government pension plans should be funded is a controversial one. For a discussion of this question, see John R. Ferguson, "The Impact of Pension Funds on the Canadian Economy," an address to the Montreal Economics Association, January 1972.

For our purposes, we will initially divide pension plans into two categories: private plans and public plans. The emphasis in this chapter is on private pension plans but for completeness, public pension plans will be reviewed as well.

Private plans are further divided into group plans and individual registered retirement savings plans. Group plans are run for groups with a common bond such as employees of firms, government employees or members of a religious organization. Registered retirement savings plans are individual retirement savings programs which qualify for special tax status.

PUBLIC PENSION PLANS

Canadians are potentially eligible for a number of pension benefits. Persons reaching retirement age are entitled to Federal Old Age Security benefits. In addition, those persons with inadequate incomes are entitled to the Federal Guaranteed Income Supplement. Both of these schemes are non-funded. Until 1972, the funds needed to support these plans came from special sales, corporation and personal taxes. Since that time, however, the plans have been financed out of consolidated revenue.

Canada and Quebec Pension Plans

In addition to the foregoing plans, there is a *Canada Pension Plan* (CPP) and a *Quebec Pension Plan* (QPP), both of which went into effect in 1966. The Quebec Pension Plan applies to members of the labour force in the province of Quebec while the Canada Pension Plan applies to labour force members of all other provinces. The two plans are essentially the same. Both the employer and the employee must make compulsory contributions to the pension plan and, in return, the employee is eligible for retirement pensions, death benefits and disability benefits. Both plans are partially funded. The CPP lends all of its excess contributions to the provinces at an interest rate based on the long-term Canada bond rate. The status of these loans as of March 31, 1974 is outlined in Table 14-1. The QPP is permitted a much broader range of investments which are managed by the Caisse de Dépôt et Placement Du Québec.

The Caisse de Dépôt et Placement Du Québec[3]

The Caisse de Dépôt et Placement Du Québec (CDPQ) is a provincial crown corporation formed in 1965 to manage funds entrusted to it by various provincial bodies. The major activity of the Fund is to invest deposits received from six boards of which the Quebec Pension Board, administrator of the Quebec Pension Plan, is the largest.[4]

3. Also known as The Quebec Deposit and Investment Fund.

4. The other boards are the Quebec Agricultural Marketing Board, Crop Insurance Board, Deposit Insurance Board, Health Insurance Board and Workmen's Compensation Commission.

Loans By The Canada Pension Plan Investment Fund as of March 31, 1974 — Table 14-1

Government	Amount $ millions	Percent
Newfoundland	128.6	1.92
Prince Edward Island	25.6	0.38
Nova Scotia	260.8	3.89
New Brunswick	197.2	2.95
Quebec	35.6	0.53
Ontario	3,703.7	55.30
Manitoba	393.4	5.88
Saskatchewan	308.5	4.61
Alberta	631.0	9.42
British Columbia	970.2	14.49
Canada	42.4	0.63
Total	6,697.0	100.00

Source: Canada Pension Plan, *Annual Report*, 1974.

Legislation creating the CDPQ gave the corporation broad investment powers similar to those of Canadian insurance companies. It should be noted, however, that the CDPQ may only acquire mortgages in Quebec and only up to 75 percent of property value unless the excess is insured. No single mortgage undertaking may exceed one-half percent of the total fund assets and the total of all uninsured mortgages may not exceed 10 percent.

Table 14-2 outlines the contents of the investment portfolio of the Fund. From the beginning, the CDPQ has had a straightforward investment strategy. Given the long-term nature of the liability and the fiduciary nature of the deposits, the CDPQ sought protection of capital and long-term investments at competitive market rates.[5] In addition, the CDPQ is viewed as a mechanism through which the economic development of the Province may be enhanced. As a result, the CDPQ devotes a high proportion of its investments to Province of Quebec and Quebec Hydro bonds. This pattern is similar to that of other provinces which, with Canada Pension Plan proceeds, have frequently purchased the securities of their crown corporations. The impact of these funds in Quebec is highlighted when one notes that in 1972, for example, the CDPQ purchased 46 percent of all Canadian placed Government of Quebec bonds and 66 percent of all Canadian placed Hydro-Quebec new bond issues.

In addition to direct investment, the CDPQ maintains a market in all current bond issues of the Province and Hydro-Quebec, in the process encouraging other investors to hold the securities. As of 1974, the CDPQ had loaned over $100

5. An actuarial study by the CDPQ completed in November 1974 indicated that by 1994 the CDPQ would stop accumulating assets and begin liquidating its portfolio. If the Quebec Pension Plan is not changed, this may soon lead to a changing investment strategy.

Assets of the Caisse de Dépôt et Placement du Québec
As of December 31 (book value in $ millions)

Table 14-2

Assets	1966	1967	1968	1969	1970	1971	1972	1973	1974
Bonds									
Government of Canada	11.9	13.1	51.4	46.7	73.3	57.9	55.7	57.1	36.7
Government of Quebec & Guarantees	119.2	236.8	394.8	538.4	711.7	882.9	1,088.5	1,317.4	1,534.2
Guaranteed By Provincial Grants	4.3	9.5	10.6	20.9	28.1	38.7	65.0	87.8	103.3
Municipal and School	15.1	36.9	56.5	83.6	98.6	106.8	121.6	141.3	183.7
Corporate	0.3	21.0	36.7	45.6	93.1	186.3	244.3	297.6	318.5
Stocks	—	47.6	99.3	156.6	212.4	280.9	352.6	491.6	601.9
Mortgages	—	—	2.7	25.5	44.7	67.2	72.9	93.2	144.9
Real Estate	—	—	1.1	4.4	14.8	20.9	20.2	22.4	24.5
Other	2.4	—	—	—	—	—	1.7	1.5	54.2
Short-Term Investments	27.6	48.0	20.5	54.2	28.6	29.4	90.9	86.0	105.0
Total	180.8	412.8	673.6	975.9	1,305.3	1,671.0	2,113.4	2,595.9	3,106.9

Source: Caisse de Dépôt et Placement Du Québec, *Annual Reports*, various issues.

million to universities, community colleges, hospitals and other bodies receiving provincial grants. The CDPQ has purchased a substantial amount of municipal and school securities, at times buying in when other investors were not available. In general, however, the short and intermediate term of these offerings has not appealed to the CDPQ although it has now begun to purchase the intermediate term securities. Purchase of corporate bonds has been substantial. The CDPQ purchases the bonds of national companies who are active in Quebec and has made private placements with medium sized firms whose shares are privately held.

Stock purchases began in 1967. The weakening in stock prices in 1973 and 1974 was interpreted by the CDPQ as a good opportunity to increase holdings. Share purchases are restricted to Canadian corporations.

The real estate and mortgage department of the CDPQ was created at the end of 1967. In 1968, the CDPQ was made an NHA approved lender. Mortgage and real estate investments have, under the charter, been restricted to Quebec and, in an effort to promote employment, have been directed at new construction. Mortgages have been granted for commercial, industrial and residential developments, the latter being primarily for multiple dwelling structures serving the low to medium rental market and insured by CMHC. Beginning in 1969, in response to a tight mortgage market, the CDPQ began seeking and receiving equity participations in projects that it financed.

The CDPQ maintains a substantial dollar amount of Government of Canada securities and other short-term investments for liquidity purposes.

Beginning in 1970, the CDPQ was permitted to manage funds entrusted to it by supplemental pension plans. By the end of 1974, the CDPQ managed the investments of five such plans, with total of $243 million.[6] Almost $190 million was contributed by the Workmen's Compensation Board. When a plan joins the CDPQ, its existing assets continue to be managed and are gradually liquidated. Supplemental pension plan contributions are then used to purchase units of three segregated funds: a bond fund, a stock fund and a mortgage fund. As of the end of 1974, the segregated funds totaled $182.7 million; these were made up of bonds $76.5 million, stocks $46.2 million, mortgages $44.7 million and other assets, primarily deposits, $15.3 million. In contrast to other plans administered by the CDPQ, these funds are heavily invested in the private sector.

Workmen's Compensation Funds

All employers in Canada are required to pay premiums into a provincial *Workmen's Compensation Fund* which is available to workmen injured in the course of

6. The five supplemental pension plans are the Government and Public Employees, University of Quebec, James Bay Development Corporation, CSN – AHPA Ministère des Affaires Sociales, and supplemental pension plans established by collective agreement decrees.

their employment. The Workmen's Compensation Fund is used to support employees while they cannot work, cover rehabilitation costs, and pay pensions to widows and dependents. Total investments held by all of these provincial funds exceeds $1 billion and although mortgages are an eligible investment for most funds their investment in mortgages is negligible.

The Ontario plan illustrates how these funds are employed for provincial purposes. The Workmen's Compensation Superannuation Fund Act permits the Workmen's Compensation Board to invest the fund in investments permitted by the Trustee Act, which permits a broad range of investments. Table 14-3 outlines the investments in the fund as of selected dates. One can see the heavy emphasis on Ontario Hydro and Province of Ontario Securities. Given that employers must make all contributions to this fund, one may speculate that the relatively conservative investment policy of the Board has led to higher contributions than may otherwise be needed.

Investments of the Workman's Compensation Board of Ontario Accident Fund as of December 31 (book value in $ millions) **Table 14-3**

	1969	1971	1973
Ontario Hydro	208.8	244.7	321.3
Province of Ontario	97.1	93.6	85.6
Government of Canada	48.2	34.7	32.9
Canadian National Railways	9.5	8.0	8.0
Manitoba Hydro	—	0.5	0.5
Municipality of Metropolitan Toronto	—	0.7	0.7
Province of Alberta	—	—	0.8
City of Windsor	1.1	0.7	0.2
NHA Mortgages	2.2	2.2	2.2
Total	366.9	385.1	452.2

Source: The Workman's Compensation Board of Ontario.

PRIVATE PENSION PLANS

Registered Retirement Savings Plans

It is possible for an individual to set up his own pension plan. In 1957, a revision of the Income Tax Act permitted the creation of a *Registered Retirement Savings Plan* (RRSP). An RRSP is an arrangement in which an individual sets aside funds to be invested and the proceeds are returned to him when he retires. The amount set aside each year, up to the limit provided in the Act, may be deducted from taxable income.[7] At retirement, the contributor has the option of buying an

7. More specifically, a person who is self-employed or employed by a firm which has no pension plan may contribute $4,000 or 20 percent of earned income per year, whichever is less; a member of a non-contributory company plan may contribute $2,500 or 20 percent of earned income, whichever is less; and a member of a contributory plan may contribute so that his combined contributions are $2,500 or 20 percent of earned income.

annuity or cashing in the RRSP. When an annuity is purchased, it is for life and may be guaranteed for up to 15 years. Each annuity payment is considered to be taxable income when received. Alternatively, when a contributor wishes to withdraw his funds, the RRSP must be de-registered and all proceeds become immediately taxable. Some of the tax burden of this abnormal flow of income may be relieved through the use of the income averaging provisions of the Act. Although contributors are sometimes advised to borrow in order to invest in RRSP's, income tax regulations do not permit the use of RRSP's as collateral for a loan.[8] Contributions made during the calendar year or within 60 days after year end are eligible for tax exemption. The funds may be invested in securities permitted in employer pension plans but there is no 10 percent limit on the investment in any one security.[9]

An investor may administer his own RRSP or purchase a plan sold by a trust company, life insurance company, bank or mutual fund organization. From the time the law was passed in 1957 until 1972, almost 850,000 RRSP's were registered with financial institutions. Of this total, about 44 percent were with life insurance companies and 37 percent were with trust companies. Table 14-4 outlines the number of new plans registered in recent years.

Registered Retirement Savings Plans Registered in Selected Years and Total Since 1957 **Table 14-4**

	Added In 1969	Added In 1970	Added In 1971	Added In 1972	Total 1957 To 1972
Life Insurance and Fraternal Societies	30,803	41,332	85,959	115,224	373,951
Trust Companies	22,152	23,814	78,174	104,435	311,794
Mutual Funds, etc.	16,228	6,512	13,336	28,188	88,960
Corporations Approved by Order-in-Council	3,476	5,116	8,763	13,571	52,881
Government Annuities	275	209	186	—	21,012
Total	72,934	76,983	186,412	261,418	848,598

Source: Roy Jenkins and Reginal Kayler, *Life Insurance and Taxation,* 15th ed., Toronto: Life Underwriters Association of Canada, June 1974.

8. For a discussion of the investment merits of RRSP's, see "The Sales Push Mounts – What Can RRSP's Do For You," *The Financial Post*, Toronto, January 19, 1974.

9. For details of permitted securities, see H. Heward Stikeman, *Income Tax Act Annotated, 4th Tax Reform Edition, 1974-75*, Toronto: Richard De Boo Limited, 1974, s.146(1) and s. 204 (e).

A self-administered RRSP allows the investor to make his own investment decisions rather than delegating that responsibility to a financial institution. Some of the investment dealers, most notably Merrill Lynch and Royal Securities, have encouraged self-administration in an effort to sell their research and trading expertise. In a self-administered plan, all transactions are done through a broker and the plan must be handled by a trust company which looks after registration, holds the securities, and keeps records of transactions. In return for these activities the trust company charges a basic fee of $50 to $250 or one-half to three-quarters of one percent of the value of the portfolio, whichever is larger. This fee covers a number of free transactions per year but there is an added charge for each transaction above this maximum. Some trust companies consider this type of business uneconomic but others, notably Guaranty Trust, have made a substantial commitment to this field. Although it is difficult to obtain data in this area, it has been estimated that of all self-administered plans approximately 25 percent contain mortgages.[10]

Life insurance companies issue policies for which they receive premiums. With the passage of RRSP legislation, it was natural for them to issue deferred life annuity policies which qualified as RRSP's. A 1961 change in the Canadian and British Insurance Companies Act permitted insurance companies to contract variable annuities based upon the performance of segregated funds. This resulted in life insurance companies offering plans that have a variety of insurance features. These include a waiver of annual premium if disability occurs or a permanent life insurance policy where the savings portion of the premium qualifies as an RRSP.

A plan offered by Canada Life Assurance Company illustrates some of the features of life insurance company RRSP policies. The applicant purchases a deferred life annuity, the benefits of which are based on the performance of an equity fund (S-9) and an income fund (S-19). The policy-owner pays a $40 fee at the time of the first premium payment and a further percentage of the first and all subsequent premiums to cover administrative expenses and insurance guarantees. The balance of the premium, after expense charges, is used to purchase units in the S-9 or S-19 fund at the discretion of the applicant. The assets in the two segregated funds are valued weekly. Retirement income takes the form of a variable annuity, the amount of which depends on the value of the assets in the fund. The policy-owner may elect to convert his variable annuity to a fixed annuity. The plan provides for a guaranteed minimum policy value, at commencement of annuity, of 75 percent of the total premiums paid. It also provides for death benefits prior to the first annuity payment of at least the return of all premium payments. Both of these guarantees are backed by the general funds of the company.

10. For a further discussion of self-administered RRSP's, see "Do-It-Yourself RRSP's Attracting New Interest," *The Globe and Mail*, Toronto, January 24, 1974 and for a brief discussion of the role of mortgages, see "Running Your Own RRSP Pays Off," *Financial Times*, Montreal, October 14, 1974.

Although it would be of interest to discuss the investments held by insurance company RRSP's, they are difficult to isolate. Some of the investments are lumped in for reporting purposes with other segregated funds related to group pension plans. Also, the savings portions of life insurance policies and the fixed annuities are combined with general insurance company funds. In a later section of this chapter, some insight into RRSP investments of insurance companies may be acquired when segregated funds are discussed in more detail.

Trust companies offer RRSP's in much the same way as life insurance companies but without the insurance options. Upon maturity of the plan, a life annuity must be purchased from a life insurance company. Trust companies normally have no acquisition fee for joining the plan but do have a monthly administration charge which is about one-twelfth of one percent of the value of the assets administered.

An example of the reaction of a trust company to the income tax legislation creating RRSP's is the case of Canada Permanent Trust Company. Beginning in 1957, this firm introduced its first retirement savings plan. This plan provides three different funds in which money can be invested including an equity fund, a fixed income fund, and a guaranteed fund. Participants can purchase units based on the value of the funds on the last business day of each month. The equity fund consists of a group of common stocks which are largely Canadian. The fixed income fund is invested in bonds, debentures, mortgages and other fixed income securities. The guaranteed fund is invested in Canada Permanent Trust Company certificates and these contributions are in turn invested in securities which are authorized under the Trust Companies Act. The guaranteed fund is guaranteed as to principal but not as to rate of return.

Chartered banks are more recent arrivals in the RRSP business but are competing aggressively by selling the funds through their branch network. The Royal Bank, for example, sponsors two funds: Royfund Limited, which invests primarily in equities and Royfund Income Trust, which invests in fixed income securities. Other banks have also entered the RRSP business.

A review of the mortgage investment practices of RRSP's is useful at this point. A careful reading of the available data suggests that most of the so-called "balanced" or "fixed income" RRSP funds are not invested in mortgages to a significant degree. One possible exception is the Royfund Income Trust which, as of December 31, 1974, had 29 percent of its $20.2 million of assets in mortgages. However, there is an increasing number of RRSP's invested totally in mortgages. The most significant is the Royal Trust M Fund. This fund had assets at the end of 1974 of $319 million, invested primarily in conventional first mortgages. Metropolitan Trust reactivated a mortgage fund originally begun in 1964 and was followed by Montreal Trust, Guaranty Trust and others. Although it is too early to say how successful these mortgage funds are likely to be, the good results of the M fund, combined with historically high mortgage yields and a sluggish stock market, would suggest that prospects are quite good. Since these are open-ended funds and mortgages are generally considered to be quite illiquid, the trust companies must guarantee purchase of some of the mortgage portfolio if required.

This may act as a constraint on the growth of these funds especially for the smaller trust companies. A number of life insurance companies are beginning to market mortgage backed policies as RRSP's. As recently as 1972, real estate and mortgage investments in segregated funds were limited to 15 percent of assets by the Superintendents of Insurance but as that rule is relaxed mortgage investments by insurance company RRSP's may climb somewhat.[11]

Employee Related Plans and Their Regulation

There are a large number of private group pension plans in Canada. For many years, these plans were subjected to minimal regulation by government. Beginning in 1965, several of the provinces initiated legislation to govern the operation of pension plans. The first legislation was contained in the Pension Benefits Act passed in Ontario in 1965. This was followed by similar acts in Quebec (1966), Alberta (1967) and Saskatchewan (1969).[12] A federal Pension Benefits Act was passed in 1967. The remaining provinces do not have pension benefits acts at the present time.

Most pension plans must be registered with provincial authorities and are subject to provincial government regulations which are quite similar from one province to another. All registered pension plans must be advance funded in accordance with anticipated needs as determined by the nature of the plan and the opinion of an actuary.

The investments permitted by provincial regulations are basically the same as those permitted under the Canadian and British Insurance Companies Act but the proportions allowed differ significantly. The pension fund is not limited regarding the proportion of various types of eligible investments that it can hold. It is, however, limited to a maximum of 10 percent of the book value of the pension fund in the securities of any one firm or person and a maximum of two percent of the book value of the fund in any single real estate project. There is a basket clause which permits up to seven percent of the book value of the assets to be invested in investments not otherwise permitted, although the amount invested in any one piece of real estate under the basket cannot exceed one percent of the book value of the pension fund's assets. The pension fund may invest its money in pooled funds of trust companies, segregated funds of insurance companies, or mutual funds, as long as these funds are placed in investments permitted under the Pension Benefits Act. Pension funds can be invested in the shares of a corporation whose assets are at least 98 percent cash, investments and loans and who do not issue debt obligations.

In addition to being registered under the Pension Benefits Act, a pension fund should register under the Income Tax Act. When this happens, it qualifies for tax

11. For some background on this controversy, see "At Least Three Insurance Firms Ready to sell Mortgage Backed Policy," *The Globe and Mail*, Toronto, October 9, 1973.

12. In Quebec the act is called The Supplemental Pension Plan Act.

free status until the capital and profits generated by the fund are returned to the employee involved. There are no fixed regulations which govern the registration of pension plans for income tax purposes. However, from time to time, guides have been published by the Department of National Revenue to give pension planners an indication as to the rules regarding registration and the circumstances under which employers are allowed to deduct contributions to pension funds from taxable income.[13] By and large, to qualify for registration for tax purposes the pension fund has to meet the requirements of the relevant provincial benefits act. Failing that, they must meet the requirements of the comparable federal Pension Benefits Standards Act. It is interesting to note that the income tax regulations stipulate that if a pension fund holds foreign securities in excess of 10 percent of the book value of the fund, it is subject to a special tax. Assets may be transferred between pension plans, from pension plans to registered retirement savings plans, or to deferred profit sharing plans without the imposition of tax.

The Funding of Group Pension Plans[14]

In terms of dollars invested, private group pension plans are more significant than public pension plans or registered retirement savings plans. Group plans are created to meet the needs of particular groups such as civil servants, employees of a company or members of a trade association. The plans may be unfunded (in the case of government employees only) or may be funded through a trusteed plan, a life insurance group annuity, a segregated fund or a Canadian government group annuity. The assets associated with these various funding methods are seen in Table 14-5.

There are 19 pension plans in Canada covering almost 22 percent of all pension plan members which may be classified as government consolidated revenue pension funds. These plans cover public servants such as federal employees, the RCMP, provincial employees and the Canadian Armed Forces. They have no invested assets since all contributions become part of the consolidated revenue of the government and a bookkeeping entry is made to record the liability.

Almost three-quarters of all group pension plan assets are funded through trusteed plans. A *trusteed pension plan* is one in which funds are placed with a trustee who is responsible for holding and investing the funds and paying out benefits in accordance with the terms of a trust agreement. The trustee does not guarantee the rate of return on the fund or the employer's obligations under the pension plan. The employer, and frequently the employees, make contributions which are expected to be sufficient to meet the pension benefits in the contract. If, according to the actuary, there are inadequate assets in the plan, the contributors must

13. See, for example, *Information Circular No. 72-13R — Employees' Pension Plans*, Ottawa: Department of National Revenue, June 19, 1974.

14. For a good discussion of private pension plan funding, see Harry Weitz, "Private Pension Fund Reserves," an unpublished paper written for Pension Section, Labour Division, Statistics Canada.

Assets of Private Group Pension Plans by Funding Instrument, Selected Years (at book value)

Table 14-5

	1965		1967		1969		1971		1973	
	$ thousands	Percent	$ thousands	Percent	$ thousands	Percent	$ thousands	Percent	$ thousands	Percent
Trusteed	6,541	68.1	8,068	69.6	10,003	71.4	12,461	72.2	16,171	72.6
Life Insurance										
(a) Group Annuities*	2,333	24.3	2,692	23.2	2,969	21.2	3,346	19.4	3,804	17.1
(b) Segregated Funds**	94	1.0	194	1.7	401	2.9	827	4.8	1,694	7.6
Canadian Government Group Annuities	634	6.6	636	5.5	634	4.5	624	3.4	617	2.7
Total	9,602	100.0	11,590	100.0	14,007	100.0	17,258	100.0	22,286	100.0

*This figure has been estimated by Statistics Canada and includes funds set aside under deposit administration plans.

**This figure includes both group pension plan and registered retirement savings plan assets.

Source: Statistics Canada, *Trusteed Pension Plans Financial Statistics*, 1973.

make up the deficiency. The trustee may administer the investments of the fund in accordance with the advice of a pension committee or an investment counsellor or both. The contributions may be pooled with the contributions of other unrelated pension plans. This pooling gives pension planners an opportunity to diversify their risk, while at the same time obtaining professional pension fund management.

Life insurance companies offer three major types of plans: group annuities, deposit administration and segregated funds. A *group annuity* is a contract between an employer and a life insurance company in which the employer pays sums of money to the insurance company and the insurance company guarantees some rate of return on the investment. This type of plan provides the employer with the assurance that he has funded, to some extent, his future pension requirements. Under *deposit administration*, the employer gives funds to the insurance company which are invested in the general assets of the company. The capital and a minimum rate of return are guaranteed; the actual return is related to the yield the insurance company is able to achieve on its general assets. Upon retirement of an employee, an annuity is purchased for him out of the deposit fund. Because of the relative inflexibility in the way that group annuity funds could be invested, the Canadian and British Insurance Companies Act was amended in 1961 to permit the establishment of so-called segregated funds. A *segregated fund* can be managed in the same way as a trusteed pension fund since there is no restriction on the proportion of assets in any particular investment.

The final type of pension funding method is the *government annuity*. The Canadian government and the government of Alberta offer annuities to the public which provide a guaranteed rate of return in much the same way as life insurance group annuities. However, the rate of return offered through government annuity plans is relatively low compared with other plans. Consequently, the only growth that has taken place in recent years has been through reinvestment of existing funds.

The objective in the remainder of this chapter is to discuss in greater detail the investments of trusteed pension plans and segregated funds of insurance companies. Group annuity and deposit administration investments of insurance companies are included with general life insurance company investments which are discussed in Chapter 12.

TRUSTEED PENSION FUNDS

Investments by Type of Trustee

Pension plans must be insured or have a trustee. An employer may set itself up as a trustee through a trust agreement, or a trust company may become the trustee, the latter arrangement being called a *corporate trustee*. In some cases employers manage part of the pension fund and have the remainder managed by a corporate trustee. A corporate trustee may manage the funds individually, place them all in a pooled fund with the investments of other pension plans, or pursue some combination of the two approaches. The assets invested under these various trust arrangements are indicated in Table 14-6.

Assets of Trusted Pension Plans in Canada at Market Value
By Type of Trust Arrangement, 1973

Table 14-6

Assets	Corporate Trusteed													
	Individually Managed		Pooled		Combinations of Individually Managed and Pooled		Pension Fund Society		Individual Trustee		Combinations of Corporate Trustee and Individual Trustee		Total	
	$ thousands	%	$ thousands	%	$ thousands	%	$ thousands	%	$ thousands	%	$ thousands	%	$ thousands	%
Bonds	819	32.7	—	—	725	25.3	534	46.0	4,808	57.5	294	45.2	7,180	44.4
Stocks	1,248	49.9	—	—	1,436	50.1	366	31.6	1,891	22.6	112	17.2	5,053	31.3
Mortgages	209	8.4	—	—	183	6.4	177	15.3	925	11.1	40	6.1	1,534	9.5
Real Estate	8	0.3	—	—	11	0.4	3	0.3	27	0.3	1	0.2	50	0.3
Cash & Misc.	206	8.2	17	2.8	192	6.7	64	5.5	673	8.0	36	5.5	1,188	7.4
Pooled Funds	—	—	591	97.2	319	11.1	16	1.3	—	—	159	24.4	1,085	6.7
Mutual Funds	14	0.5	—	—	3	—	—	—	40	0.5	9	1.4	66	0.4
Total	2,504	100.0	608	100.0	2,869	100.0	1,160	100.0	8,364	100.0	651	100.0	16,156	100.0

Source: Statistics Canada, *Trusteed Pension Plans Financial Statistics*, 1973.

Trust companies offer their clients units of a wide variety of pooled funds including equity, fixed income, diversified, mortgage and foreign investment funds. Pooled funds are attractive to the smaller pension plans as they provide investment in a diversified group of securities as well as qualified fund management. Some employer managed funds handle some of their own portfolio and purchase units in a pooled fund as well in order to obtain an investment of a certain type, such as mortgages. Table 14-7 indicates the types of pooled funds trust company clients invested in during 1972 and 1973. It is apparent that mortgage funds became more popular over the period. This popularity is reflected in the increasing number of pooled mortgage funds. A high proportion of the mortgages in these pooled funds, approximately 85 percent, were conventional as opposed to NHA mortgages.

Trust Company Pooled Pension Funds at Market Value by Type of Fund, 1972 and 1973 **Table 14-7**

	1972		1973	
	$ millions	**Percent**	**$ millions**	**Percent**
Equity Fund	410	37.5	433	39.9
Fixed Income Fund	158	14.5	171	15.8
Diversified Fund	177	16.2	62	5.7
Mortgage Fund	255	20.6	295	27.2
Foreign Fund	70	6.4	50	4.6
Other	52	4.8	74	6.8
Total	1,092	100.0	1,085	100.0

Source: Statistics Canada, *Trusteed Pension Plans Financial Statistics,* 1973.

Pension Plans of Employees in the Public and Private Sectors

The type of employer has a substantial impact on the way in which pension plan assets are invested. Table 14-8 itemizes pension fund assets held by type of employer while Tables 14-9 and 14-10 show how pension fund portfolios differ when the employees are in the public as opposed to the private sector. As indicated, there is a strong tendency for municipal and provincial governments and educational institutions to invest in provincial government bonds and to hold relatively lower proportions of stocks. The private sector invests more heavily in pooled funds, reflecting the smaller size of many of the plans. It is apparent that the public sector has traditionally emphasized NHA mortgages rather than conventional mortgages although the balance is shifting.

Market Value of Assets of Trusteed Pension Plans
By Type of Organization, 1973.

Table 14-8

	Municipalities and Municipal Enterprises		Provincial Crown Corporations and Gov't Agencies		Federal Crown Corporations and Gov't Agencies		Religious and Charitable		Educational		Health		Trade and Employee Associations		Co-operatives		Industry		Total	
	$ millions	%	$ millions	%	$ millions	%	$ millions	%	$ millions	%	$ millions	%	$ millions	%	$ millions	%	$ millions	%	$ millions	%
Investment in pooled pension funds	56	3.1	11	0.8	19	1.3	4	2.4	45	2.0	26	7.5	12	63.1	10	10.1	901	10.4	1,084	6.7
Investment in mutual funds	7	0.4	—	—	30	2.0	1	0.6	3	0.1	—	—	—	—	—	—	26	0.3	67	0.4
Bonds																				
Government of Canada	15	0.8	43	3.0	81	5.4	13	7.9	22	1.0	1	0.3	1	5.3	9	0.1	128	1.5	1,305	8.0
Provincial Government	892	50.0	736	52.1	119	7.9	18	10.9	1,497	66.2	20	5.8	1	5.3	9	9.1	638	7.3	3,930	24.1
Municipal School Board, etc.	376	21.1	48	3.4	18	1.2	14	8.5	54	2.4	7	2.0	1	5.3	3	3.0	160	1.8	681	4.2
Other Canadian	159	8.9	143	10.1	160	10.6	41	24.8	134	5.9	59	17.0	1	5.3	32	32.3	1,514	17.4	2,243	13.8
Non-Canadian	—	—	—	—	—	—	—	—	—	—	4	1.2	—	—	—	—	15	0.2	19	0.1
Total Bonds	1,442	80.8	970	68.7	378	25.1	86	52.1	1,707	75.5	91	26.2	4	21.1	45	45.5	2,455	28.2	7,178	44.0
Stocks																				
Canadian Common	114	6.4	153	10.8	417	27.7	40	24.2	189	8.4	158	45.5	3	15.8	27	27.3	3,268	37.5	4,369	26.8
Canadian Preferred	2	0.1	10	0.7	6	0.4	1	0.6	6	0.3	1	0.3	—	—	—	—	58	0.7	84	0.5
Non-Canadian Common	4	0.2	40	2.8	85	5.6	8	4.8	10	0.4	17	4.9	—	—	—	—	426	4.9	590	3.6
Non-Canadian Preferred	—	—	—	—	2	0.1	—	—	1	0.1	4	1.2	—	—	—	—	4	—	11	0.1
Total Stocks	120	6.7	203	14.4	510	33.8	49	29.7	206	9.1	180	51.9	3	15.8	27	27.3	3,756	43.2	5,054	31.0
Mortgages																				
NHA	34	1.9	122	8.6	279	18.5	12	7.3	40	1.8	14	4.0	—	—	3	3.0	379	4.4	883	5.4
Conventional	49	2.7	28	2.0	146	9.7	6	3.6	13	0.6	6	1.7	—	—	5	5.1	393	4.5	646	4.0
Total Mortgages	83	4.7	150	10.6	425	28.2	18	10.9	53	2.3	20	5.8	—	—	8	8.1	772	8.9	1,529	9.4
Miscellaneous	76	4.3	78	5.5	145	9.6	7	4.3	247	10.9	30	8.6	—	—	9	9.0	794	9.0	1,386	8.5
TOTAL	1,784	100.0	1,412	100.0	1,507	100.0	165	100.0	2,261	100.0	347	100.0	19	100.0	99	100.0	8,704	100.0	16,298	100.0

Note: Figures may not add due to rounding.

Source: Statistics Canada, *Trusteed Pension Plan Financial Statistics*, 1973.

Assets at Market Value of Public Sector Employee Trusteed Pension Plans by Asset Category, Selected Years* — **Table 14-9**

Assets	1965**		1969		1973	
	$ millions	Percent	$ millions	Percent	$ millions	Percent
Bonds	1,971	78.3	2,426	66.6	4,498	64.6
Stocks	143	5.7	473	13.0	1,038	14.9
NHA Mortgages	229	9.1	256	7.0	478	6.9
Conventional Mortgages	26	1.0	131	3.6	237	3.4
Real Estate and Misc.	108	4.3	252	6.8	544	7.7
Pooled Funds	17	0.7	64	1.8	130	1.9
Mutual Funds	22	0.9	42	1.2	39	0.6
Total	2,516	100.0	3,644	100.0	6,964	100.0

*A public sector employee is one who works for a federal, provincial or municipal government or crown corporation or who works in a public educational institution.

** Data for 1965 were only available at book value. The estimated percentages at market value are:

Bonds	76.1
Stocks	7.5
NHA Mortgages	9.2
Conventional Mortgages	1.0
Real Estate & Misc.	4.4
Pooled Funds	0.7
Mutual Funds	1.1
Total	100.0

Source: Statistics Canada, *Trusteed Pension Plans Financial Statistics,* various issues.

Assets at Market Value of Private Sector Employee
Trusteed Pension Plans by Asset Category, selected Years

Table 14-10

Assets	1965*		1969		1973	
	$ millions	Percent	$ millions	Percent	$ millions	Percent
Bonds	2,259	55.3	1,844	32.3	2,682	28.6
Stocks	851	20.8	2,325	40.8	4,014	42.7
NHA Mortgages	157	3.8	178	3.1	408	4.3
Conventional Mortgages	213	5.2	291	5.1	411	4.4
Real Estate & Misc.	184	4.6	375	6.6	897	9.5
Pooled Funds	410	10.0	669	11.7	955	10.2
Mutual Funds	10	0.3	24	0.4	26	0.3
Total	4,084	100.0	5,706	100.0	9,393	100.0

* Data for 1965 were only available at book value. The estimated percentages at market value are:

Bonds	50.6
Stocks	26.0
NHA Mortgages	3.7
Conventional Mortgages	5.0
Real Estate & Misc.	4.2
Pooled Funds	10.2
Mutual Funds	0.3
Total	100.0

Source: Statistics Canada, *Trusteed Pension Plans Financial Statistics*, 1973.

Value of Pension Fund Assets and Mortgage
Holdings of Canada's Largest Crown Corporations,*
December 31, 1973

Table 14-11

Pension Fund	Assets $ millions	Mortgages $ millions	Percent
CMHC	58.9	27.7	47.1
Bank of Canada	48.2	8.8	18.3
CNR	1,752.1	260.8	14.9
CBC	111.0	22.9	20.7

*At the end of 1974, Air Canada's pension fund had assets of over $250 million, 35 percent of which were in mortgages.

Source: The managers of the respective funds.

With respect to mortgages, federal crown corporations are the largest proportionate investors. A survey of several of these corporations disclosed that they all had above average proportions in mortgages. These results are seen in Table 14-11. Municipal and educational organizations placed a rather low emphasis on mortgages perhaps reflecting the fact that they had restrictive investment policies.

The CMHC Survey of Pension Funds

During the period March 1969 to January 1970, a survey of pension and similar funds administered by provincial and municipal authorities was conducted on behalf of the Central Mortgage and Housing Corporation.[15] The survey consisted of visits to all of the provinces and major municipalities in Canada to determine how their funds were administered and how the funds were being invested. Although the data are now badly dated and do not reconcile well with the data provided by Statistics Canada, they provide useful insight into public sector pension fund management.

Table 14-12 outlines the 41 pension plans that were administered by provinces at the time of the survey. Of the 41 plans, nine were non-funded and three were

Assets and Mortgages Held by All Provincially Administered Pension Plans, 1969 **Table 14-12**

Province	Number of Plans (Number Unfunded)	Total Assets $ millions	Mortgages Held	
			$ millions	Percent of Total
Alberta	4 (2)	102.5	6.7	6.54
British Columbia	6 (0)	516.0	—	—
Manitoba	3 (0)	100.4	2.4	2.39
New Brunswick	2 (1)	11.0	—	—
Newfoundland	2 (2)	—	—	—
Nova Scotia	2 (0)	115.0	12.5	10.87
Ontario	5 (1)	1,065.0	20.8	1.95
Prince Edward Island	2 (0)	4.0	—	—
Quebec	4 (2)	1,050.0	30.0	2.86
Saskatchewan	11 (1)	94.4	2.2	2.33
Total	41 (9)	3,058.3	74.6	2.44

Source: J.K. Rae and J.R. Ferguson, *Survey of Pension and Similar Funds Administered by Provincial and Municipal Authorities,* Ottawa, CMHC, February 1970. This was an internal staff report.

15. See J.K. Rae and John R. Ferguson, *Survey of Pension and Similar Funds Administered by Provincial and Municipal Authorities*, Ottawa: CMHC, February 1970. This was an internal staff report.

partially funded in that the employees made contributions but the government contribution came from consolidated revenue funds. Of the 29 funded plans, eight plans totaling over $1.3 billion in assets could only be invested in the non-marketable assets of the provincial governments. The remaining plans heavily emphasized investment in provincial and municipal securities. Mortgages represented a negligible 2.44 percent of all provincial pension fund assets at the time of the survey.

The researchers also surveyed 20 pension plans administered by municipal authorities. The results are seen in Table 14-13. All of the municipalities surveyed were permitted to invest their funds in mortgages and the proportion of these funds was close to the national average for all financial institutions. The types of plans available for municipal employees varied from pay-as-you-go plans to fully funded flexible investment programs. Since 1968, all new Ontario municipal employees have had to contribute to a pension fund administered by the provincial government, the Ontario Municipal Employees Retirement System Fund (OMERS). The provincial government funds this plan but at the moment all of the contributions are invested in non-marketable Ontario government securities.

Assets and Mortgages Held by The Pension Funds of 20 of Canada's Larger Municipal Governments, 1969

Table 14-13

Province	Number of Municipal Governments Interviewed	Estimated Total Assets $ millions	Mortgages Held $ millions	Percent of Total
Alberta	2	71.0	3.5	4.9
British Columbia	(All municipalities were members of the provincially administered "Municipal Employees Fund.")			
Manitoba	2	61.0	3.0	4.9
New Brunswick	3	9.2	0.2	0.2
Newfoundland		(not funded)		
Nova Scotia	1	10.0	—	—
Ontario	6	220.0	6.5	3.0
Prince Edward Island	1	0.5	—	—
Quebec	3	203.4	36.1	17.7
Saskatchewan	2	12.9	1.2	9.3
Total	20	588.0	50.5	8.6

Source: J.K. Rae and J.R. Ferguson, *Survey of Pension and Similar Funds Administered by Provincial and Municipal Authorities,* Ottawa, CMHC, February 1970. This was an internal staff report.

In future, it is anticipated that a portion of the assets will be independently invested by OMERS. British Columbia administers a similar provincial pension plan and Alberta has a modified version of the Ontario plan. Because these three provinces do not invest their funds in mortgages, a substantial amount of potential money is removed from the mortgage market.

The authors of the CMHC sponsored study reached a number of conclusions regarding the role of mortgages in provincial and municipal pension plans. They concluded that many of the officials were uninformed about mortgages as investments and were under the impression that mortgages were difficult to administer, that foreclosures might present embarrassing problems, and that the insurance feature of NHA loans might not provide sufficient protection against loss. They also noted that provincial pension plans were not generally managed in such a way as to maximize returns. Instead, one of the primary objectives was to provide funds for provincial and municipal purposes.

From a legislative standpoint, the authors concluded that there appeared to be no restrictions preventing the investment of municipal funds in mortgages and that there was a need to revise the provincial trustee acts to allow funds to be more freely invested in mortgages. They recommended that government administered funds delete the restrictions in their pension fund acts and by-laws that prevented the investment of funds in mortgages.

SEGREGATED FUNDS

As discussed earlier, legislation creating segregated funds within life insurance companies was first passed in 1961. A segregated fund is simply a fund which is kept separate from all other insurance company assets. Insurance companies may receive deposits which are invested in a broad range of securities. The return to the depositor depends on the investment performance of the fund. Insurance companies set up individual or pooled funds for pension plans in the same way as trust companies. As a result, there is little distinction between a trust company pension fund and an insurance company segregated fund.

Table 14-14 outlines the Canadian assets of the segregated funds of all Canadian, British and foreign life insurance companies in Canada for various years. The two most impressive features of the data are the rapid growth and the significant shift in portfolio composition. From 1964 to 1973, the proportion of bonds held dropped from 40 percent to 21 percent and the proportion of mortgages decreased from 34 percent to 16 percent. At the same time, the proportion of common stock rose from 23 percent to 57 percent. Since the assets in segregated funds are the result of depositors' choices plus the portfolio strategy of the insurance companies themselves, it is difficult to explain why there has been such a drastic portfolio shift. One may speculate that insurance companies initially exhibited their historical preference for long-term fixed income securities by purchasing bonds and mortgages. Then, faced with the greater emphasis on performance and the widespread belief that a diversified portfolio of stocks would provide a superior return, the segregated funds began to emphasize equities.

Segregated funds contain proportionately more equity and mortgages than trust company funds. It should be noted, however, that the proportion of mortgages held in segregated funds declined rapidly during the nine year period under consideration and may yet approach the proportion of mortgage funds in private sector trusteed plans.

Canadian Assets of Segregated Funds of Canadian, British and Foreign Life Insurance Companies, Selected Years

Table 14-14

	1964		1967*		1970*		1973*	
	$ millions	Percent	$ millions	Percent	$ millions	Percent	$ millions	Percent
Bonds	24.2	40	63.4	33	153.5	28	361.1	21
Stocks	14.3	23	63.4	33	250.6	46	965.1	57
Mortgages	20.6	34	56.6	31	180.7	21	275.9	16
Miscellaneous	1.8	3	6.5	3	27.4	5	87.8	6
Total	60.9	100	189.9	100	540.2	100	1,689.9	100

* From 1967 to present, figures for assets of Canadian life insurance companies segregated funds have been broken out between assets inside and assets outside Canada in the data source. Only assets inside Canada are included in the above table. In 1973, the assets of segregated funds outside Canada were $252.7 million, $4.6 million of which were mortgages. All data are at market value.

Source: *Report of the Superintendent of Insurance for Canada,* various issues.

The proportion of various securities held varies from one insurance company to another. Table 14-15 shows the assets of the segregated funds of several firms. Great-West Life, with a heavy reliance on mortgages, may be compared with Manufacturers Life, which has a low proportion of mortgages. Incidentally, this difference in emphasis is reflected to some degree in the general life insurance assets of these two firms.

Canadian Assets of Segregated Funds of Selected Life Insurance Companies at Market Value, 1973

Table 14-15

	Total	Proportion of Total Assets				
	$ millions	Bonds	Stocks	Mortgages	Misc.	Total
Canada Life	184.2	32.8	43.2	22.0	2.0	100.0
Confederation Life	162.1	30.4	51.2	8.5	9.9	100.0
Great-West Life	108.7	2.5	33.2	53.9	10.4	100.0
Manufacturers Life	131.7	22.7	73.3	—	4.0	100.0
National Life	95.4	33.5	55.1	10.2	1.2	100.0
North American Life	83.4	19.4	54.4	24.7	1.5	100.0
Sun Life	373.4	20.6	60.3	17.1	2.0	100.0

Source: *Report of the Superintendent of Insurance for Canada,* 1973.

PENSION FUND PORTFOLIO MANAGEMENT

Overall Investment Objectives

The employer sets up a pension plan which provides for the payment of future benefits upon retirement. The simplest plan is one in which the employer agrees to set aside specific amounts at regular intervals and purchases an annuity on behalf of the employee at his retirement. In this case, the uncertainty of the return on the fund is carried by the employee. Other plans, such as career average or final purchase benefit plans, simply specify the benefits to be received by the employee upon retirement. These benefits are normally based on the average, peak, or final earnings of the employee and thus are quite uncertain. To estimate future employee benefits, the employer obtains the advice of an actuary who considers such factors as mortality rates, employee turnover and future salary levels.[16] Then, given some assumption about the rate of return that can be earned by the pension fund assets, the employer sets aside sums of money each year to meet the future liability. An actuary periodically assesses the assets of the plan relative to future commitments. When an actuarial deficit exists, the firm is required to make up the deficiency over a certain number of years.[17] Because of the need for forecasting benefits and rates of return along with the absence of clear cut rules as to how securities must be valued, a variety of actuarial opinions and investment strategies are possible.

When an employer is liable for all future benefits, he is naturally concerned with maximizing the return of the fund. Since the liability is typically well into the future, the employer is normally willing to make long-term investments. However, since actuarial deficits must be made up over a relatively short period (usually five years), the manager cannot rely totally on long-term growth. The rapid growth in membership, the relative newness of many plans and the increasing contributions have all provided pension plans with a substantial annual net inflow of funds. This has resulted in liquidity becoming a secondary consideration for most funds except as an investment strategy. For example, if the stock market appears to be temporarily depressed, the manager may liquidate some of his other holdings to acquire equities. Because a pension plan is an important source of income for the retiree, a relatively cautious attitude is taken toward the risk of loss of principal. The result is an emphasis on higher grade securities.

The size of the fund has an impact on investment policy. A small pension fund is frequently placed directly into the pooled fund of a trust or life insurance company or an insured group annuity is purchased. With pooled funds the manager can choose which fund units to purchase, but the investment policy of the fund is determined by the financial institution. Larger funds are usually individually

16. For a brief discussion of the role of an actuary, see R.A. Field, "Actuarial Aspects of Pension Costs," *Pension Planning in Canada*, Toronto: The Canadian Institute of Chartered Accountants, 1970.

17. Employers are currently facing rising salaries and increasing demands for benefits along with falling stock and bond prices. For a discussion of the impact this is having on employers, see "Employers Face the Pension Gap – The Price May Be Too High," *Financial Times*, Montreal, September 9, 1974.

managed, either through a financial institution or on the advice of investment counsellors. The result is a wide diversity of investment strategies.[18]

Pension fund investment policy is made within the context of several kinds of constraints such as provincial or federal benefits acts, trustee acts and the Income Tax Act. Although the impact of these acts was outlined earlier in this chapter, it is useful at this time to recall that pension funds may generally be invested in securities permitted under the Canadian and British Insurance Companies Act and that wide latitude is permitted in the proportion of the fund invested in the various classes of securities. Another constraint on individual pension funds arises when the intent of the fund managers is to achieve some goal in addition to the funding of anticipated benefits. An example of this is where government related plans attempt to provide a market for government securities or support for local industry.

The Role of Equity, Real Estate, and Bonds

As indicated earlier, common stocks are becoming increasingly important as a pension fund investment. There is no limit on the proportion of a pension fund that may go into equities. However, there are some limitations on the types of securities that may be purchased and on the proportion of the fund that may be invested in any given equity security. There are also limitations on the proportion of the shares of any one corporation that the pension fund can buy. In spite of the trend toward increased equity in pension funds, there are a number of reasons why some pension funds may not allocate a large proportion of their funds to equities. For example, if a fund anticipates a large outflow in the near future or if the plan is very small, the pension fund may prefer to avoid a high proportion of equity.

As noted, the proportion of bonds in pension fund portfolios has been constantly declining in recent years. However, with higher interest rates and greater uncertainty in the stock market, it is possible that the attractiveness of bonds for pension fund portfolios may increase.

Current regulations allow pension funds to invest in real estate of the same type permitted by the Canadian and British Insurance Companies Act except that there is no maximum limitation on the total investment. Real estate is an attractive investment for pension funds in that it can provide long-term growth combined with some current yield. A variety of package deals are available. For example, the Alberta Government Telephones pension fund recently invested $2.36 million in a Calgary development consisting of a $860,000 loan to the

18. For a brief discussion of pension fund investment policies, see J.L. Tool, "Pension Fund Investing," *Pension Planning in Canada*, Toronto: The Canadian Institute of Chartered Accountants, 1970.

developer, $1 million for one-third equity to the developer and $500,000 for land ownership.[19]

Mortgages as Pension Fund Investments

There are a number of ways in which a pension fund may participate in the mortgage market. Smaller funds and those entering the mortgage market for the first time may obtain an interest in a diversified portfolio through the purchase of units in a pooled mortgage fund of a trust or insurance company. Larger funds, those with assets over $5 million, may make direct investments in the mortgage market. The first step would be to purchase a block of government insured mortgages on prime residential property. The smallest package of mortgages available would probably be about $100,000. The next step would be the purchase of conventional or high ratio mortgages on residential property. As expertise is acquired the lender may make mortgage loans on industrial or commercial property, perhaps including a participation feature. The next level of sophistication would be a package deal involving the purchase and leaseback of land topped off by a mortgage on a building. Finally, the pension fund may become involved in direct real estate investment either alone or with a developer.

Mortgages generally meet the investment requirements of pension funds. An investor may opt for higher or lower returns, depending on the risk he is willing to take. He may also have a hedge against inflation through participation or real estate related loans. The long terms preferred by the fund manager are available with commercial and industrial mortgages. Mortgages, through their blended principal and interest payments, provide adequate liquidity. In spite of the attractiveness of mortgages, as indicated in Table 14-16, the proportion of assets devoted to mortgages has not increased over the last decade.

Some of The Problems of Investing in Mortgages

Given the attractiveness of mortgages as investments, it is difficult to understand why they are not more popular with pension funds. Some of the real and imagined deficiencies of mortgage investments will be reviewed in this section.

Pension funds are not normally approved NHA lenders and do not have a highly developed mortgage department. They must rely on trust companies, chartered banks, mortgage brokers and investment dealers to provide them with administrative assistance and a continuous supply of mortgages. When purchasing a mortgage, the fund manager must accept the word of the seller as to the quality of the loan or be willing to appraise the loan himself. This is more difficult to do than the evaluation of a bond issued by a firm such as Bell Telephone. With a

19. For a discussion of real estate as a pension fund investment, see "The Morguard Conference on Real Estate for Pension Funds," November 1972, "Real Estate and Pension Funds," January 1973, and "Common Stocks and Real Estate," November 1973, *Canadian Mortgage Market Review*, Toronto: Morguard Trust Company.

Total Assets and Mortgages held by Trusteed Pensions Plans, 1961-1973

Table 14-16

	Total Assets At Market Value	Mortgages at Market Value in $ millions			Mortgages as Percent of Total Assets		
	$ millions	NHA	Conventional	Total	NHA	Conventional	Total
1961	4,085	231	110	341	5.6	2.7	8.3
1962	4,531	278	136	414	6.1	3.0	9.1
1963	5,209	324	155	479	6.2	3.0	9.2
1964	6,044	350	192	542	5.8	3.2	9.0
1965	6,720	367	252	619	5.5	3.7	9.2
1966	7,054	375	300	675	5.3	4.3	9.0
1967	7,864	364	356	720	4.6	4.6	9.2
1968	8,940	377	392	769	4.2	4.4	8.6
1969	9,350	434	421	855	4.6	4.5	9.1
1970	10,574	512	496	1,008	4.8	4.7	9.5
1971	12,574	638	530	1,168	5.1	4.2	9.3
1972	15,098	755	534	1,290	5.0	3.6	8.6
1973	16,303	887	647	1,534	5.4	4.0	9.4

Source: Statistics Canada, *Trusteed Pension Plans Financial Statistics,* various years.

Bell Telephone bond, the manager has a more detailed prospectus, the assurance that other investors are purchasing the security, a long repayment record by the borrower and perhaps the recommendations of a number of financial analysts. When a fund is considering mortgages insured by CMHC or a private mortgage insurance company, they have the benefit of knowing that an independent body (the insurer) has reviewed the loan and decided that it was worthy of insurance.

A diversified portfolio of NHA insured mortgages is probably as secure as a diversified portfolio of corporate bonds. However, pension funds still view mortgages as quite risky because the underlying security is real estate, an asset with which a manager is not likely to be familiar. Also, in the event of default a pension fund may feel that it has to go through a long involved process to take possession of the property. Of course, most lending institutions will perform this function on behalf of the fund. Another risk is the uncertainty of the title to the property. In order to collect under any mortgage insurance plan, the lender must transmit clear title to the property to the insurance company. If there is a title defect, this would not be possible. This, however, happens infrequently.

Another criticism often made of mortgages is that they are not liquid. This has implications for pension funds. When a pension manager is being pushed by his client for better performance, he is reluctant to freeze the assets of the pension fund into one which is non-liquid. In addition, some investment counsellors believe that a portfolio must be "managed". This means that a portfolio manager should always be able to sell parts of his portfolio in order to achieve higher performance. There are a number of possible responses to this criticism, including the fact that most pension funds do not need liquidity. Even if they did, there is no reason to believe that every item in the portfolio should be equally liquid. One might also note that the blended repayment scheme provides mortgages with built-in liquidity. It is probably true, however, that if a pension fund should desire to sell a large block of mortgages, it would take longer than some of the more publicly traded bonds.

It is possible for a pension fund to purchase a block of mortgages from a financial institution but it would likely have to accept a somewhat lower yield for immediate delivery. A more common procedure would be for the pension fund to commit the mortgage money in advance of construction and then either make a large takeout loan at completion or make advances based on construction progress. Either way, there is a high degree of uncertainty surrounding the actual outlay dates. In addition, the lender may find that he is committed to a rate which, by the time the funds are actually disbursed, is unattractive compared with the going rate. By comparison, stocks and bonds may be purchased on relatively short notice.

Due to the nature of their liabilities, pension funds prefer long-term investments. In recent years, single family residential mortgages have been written with five year terms. This means that the pension fund must either be prepared to have the

loan paid off in five years or must precommit itself to accepting the then market interest rate when the renegotiation takes place. In addition, NHA mortgages now allow the borrower to repay the mortgage in full within the first three years. The result is that a mortgage requires more attention than a long-term bond and the interest rate cannot be locked in for extended periods. Of course, in times of rising interest rates, some may see this rollover feature as an advantage. Most mortgage loans made to corporate borrowers are still long-term. Consequently, if pension funds require long-term mortgage investments, they are available.

It has been contended that there is a general lack of knowledge of mortgages among investment advisors and pension fund managers. Although there are still some regulations forbidding the investment of pension fund assets in mortgages, there is also substantial pressure to invest in securities other than mortgages. For example, investment dealers who are in constant contact with pension fund managers typically push for the sale of bonds and equities rather than mortgages, partly because they are not well informed in the mortgage area. In addition, many of the portfolio managers themselves are ex-bond and equity managers and, as a result, mortgages are not considered one of their normal investment vehicles.

It may also be pointed out that there is a shortage of good mortgage administrators within financial institutions today. Others have contended that large institutions are currently managing so much money that they cannot do justice to the management of the money. Since mortgages involve extra activities, managers simply avoid mortgages and get into vehicles with which they are more familiar. Large corporations may have investment committees that only meet occasionally. Thus, the portfolio may be worked on in the manager's spare time and receive little attention. This factor tends to work against investment in mortgage funds.

The lack of information and the misinformation in the area of mortgages is being reduced through the activities of various mortgage brokers, financial institutions and government bodies such as CMHC and provincial housing authorities. Another reason for the relatively small investment in mortgages by pension funds is the fact that it is only in recent years that institutions originating mortgages have devoted a substantial effort to marketing mortgages to pension funds.

Chapter 15

Credit Unions

The purpose of this chapter is to examine the lending activities of credit unions with particular reference to mortgages.

ORGANIZATION AND REGULATION

A credit union is a cooperative saving and lending organization formed for the mutual benefit of its members. Its operation is subject to provincial statutes and regulations as well as any by-laws passed by the membership. Among French-speaking Canadians, a credit union is called a caisse d'epargne et de credit (caisse). Most provinces have parallel credit union and caisse movements.

A *local credit union* is formed by persons with a common regional, occupational or other relationship. In Quebec, for example, by law the territory may not exceed the limits of one electoral district or municipality. In practice, the local parish traditionally forms the boundary for a caisse. In Ontario, the commonality of membership is more frequently derived from the place of employment although this is now changing to a regional orientation.

Local credit unions may join together as *central credit unions* (also called *leagues* or *federations*) which receive deposits from and lend to local unions. The central credit unions, particularly in Quebec, play a role in the inspection, regulation and provision of liquidity to members.[1] In addition, the central credit unions have become increasingly influential through their ownership of financial institutions. For example, the B.C. Central Credit Union owns Central Financial Corporation Limited which grants loans to members of local unions on a referral basis. This Corporation can also assist local credit unions through the purchase of mortgages from them. The B.C. Central has introduced a Registered Retirement Savings Plan and a Registered Home Ownership Savings Plan, both of which have proven successful. There are a number of central credit unions in Quebec, but the largest is the Federation de Quebec des Caisses Populaires Desjardins. This feder-

1. For a brief discussion of the role of the central credit union, see B.C. Central Credit Union, *The Credit Union Financial System in B.C.*, Vancouver, British Columbia, n.d.

ation accounts for 84 percent of all credit union membership in the province.[2] In Quebec, only members of the Federation de Quebec des Caisses Popularies Desjardins are entitled to the name *Caisse Populaire.* All others must be known by some other name, such as "Caisse d'epargne" or "Caisse d'economie". The Desjardin movement owns two general insurance companies, two life insurance companies and a trust company.

A number of provincial central credit unions have become members of the National Association of Canadian Credit Unions (NACCU). The financial arm of the NACCU, the Canadian Cooperative Credit Society (CCCS) is subject to the federal Cooperative Credit Associations Act.[3] In addition to accepting deposits and making loans to its members, the Society is contemplating the formation of a mortgage investment company which would purchase mortgages originated by credit unions.

The growth and impact of credit unions in the last decade has been impressive. As of 1973, there were 4,184 local credit unions in Canada with over seven million members (56 percent in Quebec and 20 percent in Ontario). Assets which stood at over $8.8 billion in 1973 (51 percent in Quebec and 20 percent in Ontario) have grown at a compound annual rate of 15 percent. In every province, the number of local credit unions exceeds the number of trust company branches and in Quebec, local credit unions outnumber bank branches (1,662 versus 1,504).

SOURCE OF FUNDS

Table 15-1 provides an overview of the assets and liabilities of local credit unions.

A local credit union issues share capital to its members at a nominal price, such as $5 or $10 per share. At the end of the year, a return is paid on the shares in the form of a dividend. Although any number of shares may be purchased, each member may only have one vote at the annual meeting of the local credit union.

Local credit unions are permitted to receive demand, savings and term deposits. Demand deposits are chequable and normally bear interest. Savings deposits are non-chequable and bear interest at competitive rates. Term deposits represent about one-third of all deposits. In recent years, most of these deposits have been from one to three years in maturity rather than the five year maturities preferred by trust companies, perhaps reflecting persistent high short-term rates. Deposits in Quebec are insured by the Quebec Deposit Insurance Corporation. Excluding

2. For an excellent discussion of the caisse populaires movement in Quebec, see R. Tremblay, *Desjardins Cooperative Movement*, Levis, Quebec: The Quebec Federation of Regional Unions of Caisse Populaires Desjardins, 1969. For a more current discussion, see "Caisse Populaires Live Up to Name," *The Globe and Mail*, Toronto, July 11, 1974.

3. Provincial federations or leagues must be certified under the federal Cooperative Credit Associations Act to be members of CCCS. Once certified, provincial leagues are subject to the provincial statute under which they are incorporated and the federal Cooperative Credit Associations Act.

Ontario, deposits in other provinces are insured by stabilization boards created by the credit unions themselves or by the provincial governments.[4] In Ontario, the movement's two stabilization funds do not provide insurance. They are used to respond to liquidity problems and to provide assistance to member credit unions in temporary financial difficulty.

Balance Sheets of Local Credit Unions, 1968, 1971, 1974 **Table 15-1**

	1968		1971		1974	
	$ millions	Percent	$ millions	Percent	$ millions	Percent
Assets						
Cash & Demand Deposits	397	10.6	638	11.5	1,396	13.6
Investments	596	15.1	1,023	18.5	1,429	13.9
Cash Loans	1,428	38.0	1,891	34.2	3,086	30.0
Mortgage Loans	1,105	29.4	1,631	29.5	4,028	39.1
Fixed & Other Assets	259	6.9	348	6.3	361	3.4
Total	3,758	100.0	5,531	100.0	10,300	100.0
Liabilities and Members' Equity.						
Accounts & Loans Payable	133	3.5	82	1.5	395	3.8
Deposits & Other	2,042	54.3	3,717	67.2	7,491	72.7
Share Capital	1,326	35.3	1,390	25.1	1,941	18.8
Retained Earnings & Reserves	257	6.9	342	6.2	473	4.7
Total	3,758	100.0	5,531	100.0	10,300	100.0

Source: *Bank of Canada Review,* various issues.

Credit unions may borrow but the sums borrowed are restricted by the size of deposits, capital and surplus.[5] In practice, local credit unions have borrowed from the federations and from other institutions to a lesser extent.

4. For example, in British Columbia the Credit Union Reserve Board has five members appointed by the Lieutenant Governor-in-Council. The Board receives assessments from each union as an insurance fee. These fees are set aside in the Provincial Credit Union Share and Deposit Guarantee Fund. In Ontario, the stabilization fund is still controlled by the credit union movement but a move is underway to have the province play a more active role. See "Clement Cites Need for Full Protection of Credit Union Funds", *The Globe and Mail,* Toronto, March 8, 1974. Eventually, credit union deposits may be insured by the Canada Deposit Insurance Corporation. See "Credit Unions, Caisse Populaires to Seek Federal Deposit Insurance". *The Globe and Mail,* Toronto, April 23, 1975.

5. In Quebec, total borrowing cannot exceed twice the sum of the union's reserves and paid-up and unimpaired capital (*The Savings and Credit Unions Act,* R.S.Q. 1964, c. 293, Sec. 74). In Ontario, the maximum debt allowed is 50 percent of the sum of capital, deposits and surplus (*The Credit Unions Act,* R.S.Q. 1970, c. 96, Sec. 39).

Credit unions are required to set aside substantial reserves from operating surpluses. These reserves provide additional capital for operations of the credit union.

In order to maintain some minimal level of liquidity, a proportion of assets (in Ontario, 10 percent of ordinary savings and 20 percent of chequing deposits) must be in the form of cash, deposits or government related securities. The remainder of assets are placed in a variety of investments and loans to members. In Ontario, for example, it may make almost all investments permitted under the Insurance Companies Act. The most popular investments are municipal and provincial securities and term deposits from centrals. Cash loans are made to meet a number of member needs. The most common cash loans are for consolidation of debts, automobile purchases and general operating expenses. The rate charged is comparable to that of chartered banks. At the end of the year, the borrower may benefit from a decrease in interest payable, based on the surplus generated for that year.

MORTGAGE LOANS

As of 1974, 39 percent of all local credit union assets were invested in mortgage loans. This $4 billion investment makes credit unions among the largest institutional mortgage lenders in Canada. The decision to make mortgage loans, as opposed to personal loans, is made at the local level and depends primarily on the members' needs and the nature of the local credit union's liabilities.[6] This results in a wide variety of practices. In 1973, for example, Nova Scotia mortgage loans were eight percent of total assets, while in British Columbia, 66 percent of assets were invested in mortgages. Table 15-2 shows the distribution of mortgage loans made by local credit unions by province.

Credit unions are only permitted to make loans to members. This does not, however, act as a severe constraint as a membership is acquired with relative ease. As indicated in Table 15-3, mortgage loans are made for a number of purposes of which the purchase of real estate is the most significant. The nature of the real estate pledged varies. Most mortgages are on single family residential properties. In Quebec, multiple family owner occupied homes are often pledged, while in Manitoba and Saskatchewan farm mortgages are significant. Few commercial or industrial loans are ever made. The highest proportion of loans are on existing as opposed to new properties.

The size of a mortgage loan is based on the size of the local union and the needs of its members. As Table 15-4 indicates, the average size of mortgage loans has been increasing in recent years reflecting rapidly rising house prices.

6. For a discussion of credit union liquidity in general and some insight into the relationship between mortgage holdings and liquidity management, see Joseph Caskenette, "Liquidity and the Credit Union Movement in Ontario," a presentation to the 34th Annual Meeting of the Ontario Credit Union League on March 7, 1974. Mr. Caskenette is the manager of the League Central, Ontario Credit Union League.

Mortgage Loans as a Percent of Total Local Credit Union Assets by Province, 1973 — **Table 15-2**

Region	Mortgage Loans in $ millions	Mortgage Loans As a Percent of Total Assets
Newfoundland	0.2	4.7
Prince Edward Island	—	—
Nova Scotia	7.5	8.3
New Brunswick	22.3	26.6
Quebec	1,460.4	35.3
Ontario	439.4	27.6
Manitoba	152.1	49.8
Saskatchewan	276.6	33.6
Alberta	75.6	23.5
British Columbia	655.4	66.0
Canada	3,089.5	36.5

Source: Statistics Canada, *Credit Unions*, 1973.

Local Credit Union Mortgage Loans Made in Canada in 1972 by Purpose of Loan* — **Table 15-3**

	$ millions	Percent of Total
Consolidation of Debt	78.4	9.9
Auto Purchase	16.7	2.1
Investments	2.9	0.4
Taxes	1.1	0.1
Home Repairs	43.2	5.5
Real Estate	617.3	77.9
Equipment	17.2	2.2
Operating Expenses	11.5	1.5
Other	4.2	0.4
Total	792.5	100.0

* Due to the way in which the raw data were collected, these data do not include the provinces of Nova Scotia and British Columbia which represented mortgage loans of $424 million in 1972.

Source: Statistics Canada, *Credit Unions*, 1972.

Average Size of Mortgage Loans Made by Credit Unions, Selected Provinces, 1970-1973

Table 15-4

Provinces	1970	1971	1972	1973
Manitoba	$ 4,693	$ N/A	$ 7,252	$ 7,325
Newfoundland	2,756	3,994	4,269	4,500
Ontario	9,605	10,826	12,979	12,693
Quebec	6,765	7,647	8,621	10,624
Saskatchewan	3,279	4,021	5,331	7,126

Source: Statistics Canada, *Credit Unions,* 1972.

Credit unions have traditionally avoided insured loans, relying instead on their knowledge of the financial strength and character of the borrower. As unions have grown, a great number have qualified as approved CMHC or private insurance company lenders. The result is an increasing number of insured loans originated by credit unions. The Mortgage Insurance Company of Canada had 62 credit union approved lenders early in 1975.

The terms of mortgages issued by credit unions are quite different from those of other financial institutions. While most local credit unions are limited by provincial statute to a maximum loan to value ratio of 75 percent, unless the excess is insured, the local credit union will often make an additional unsecured loan if it appears warranted. This raises the effective loan to value ratio although in practice it seldom exceeds 80 percent. The amortization period is 20 to 25 years or less. Although credit unions commonly employ a five year term, they frequently use terms of three years or less.[7] Mortgages are normally repayable at any time without penalty. In some parts of Canada, outside appraisers are used while in others, particularly Quebec, appraisals are done by the credit committee of the local credit union. Interest rates charged on mortgages are competitive and may be quite low at those unions that provide a year end patronage rebate based on earned surplus for the period. In some cases, such as mortgage loans made by the Caisse Populaires Desjardins, the borrower has insurance which, in the event of death or total disability, pays the amount outstanding up to $20,000.

7. In British Columbia, for example, the three year term is common while some mortgages have only a one year term. Variable terms mortgages are also being considered.

Chapter 16

Real Estate Investment Trusts and Mortgage Investment Companies

The high level of housing starts and related strong demand for mortgage funds in the 1970's led to the creation of two new financial institutions: real estate investment trusts and mortgage investment companies. In this chapter the formation and portfolio strategies of these institutions will be examined.

REAL ESTATE INVESTMENT TRUSTS

Real estate investment trusts (REIT's) arrived on the Canadian investment scene in the summer of 1972 with the successful issue of securities by a trust sponsored by the Toronto-Dominion Bank. Since that time, four other REIT's have entered the Canadian market. Although it is widely believed that REIT's will assist in filling the growing gap in the supply of mortgage funds, they have not yet reached a size that would permit an evaluation of their performance in that regard.

The Structure of a REIT

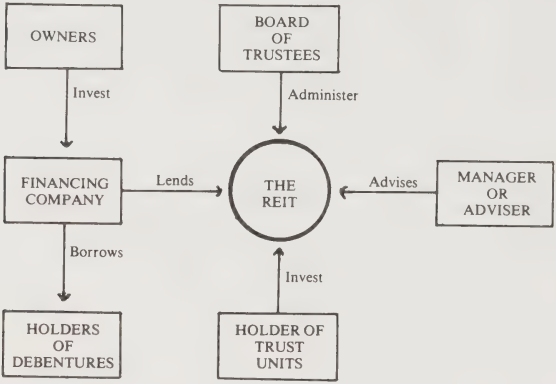
A *REIT* is created by a trust indenture which is a contract between a trustee and the settlor of the trust. The terms are governed by the trust indenture and the common law of trusts and trustees as supplemented by the Trustees Act.

REIT's were formed to invest funds in a portfolio of mortgages and other real estate related investments. They issue trust units which entitle the unit holders to share proportionately in the earnings. A REIT can issue an unlimited number of trust units and except for their tax and liability status, these are like corporate common shares. Trust units are listed and traded on a stock exchange in a similar fashion to the shares of a closed end mutual fund. For all practical purposes, unit holders can be thought of as having the same limited liability as common share-

holders.[1] As indicated in Figure 16-1, a REIT is administered by a Board of Trustees elected by the unit holders of the REIT.

The Structure of a Typical Real Estate Investment Trust

Figure 16-1



REIT's are generally managed or advised by the sponsor of the trust. The adviser originates and services mortgages and real estate investments as well as providing investment and financing advice. In return for these activities, the adviser receives a fee usually based on the dollar value of the assets being administered.

The real estate investment trust is allowed to lever the earnings of the unit holders through borrowing. A REIT cannot borrow funds directly from the public, but must borrow funds from a financing company set up to lend funds to the REIT.[2] This company issues debentures to the public and to financial institutions. It is typically owned by the adviser and is not intended to make a profit. The financing company and the adviser may, in fact, be one and the same. An overview of the structure of the five public Canadian REIT's is presented in Figure 16-2.

1. In theory, the holder of a trust unit has unlimited liability. However, in order to protect the unit holder, the trusts typically place a provision in all contracts that the obligation of the trust is not considered to be a binding obligation of the unit holder. There is some risk that a non-contractual liability, such as taxes, may arise which cannot be disavowed by the unit holders. The amount and probability of this liability occuring is small and, in some cases, is insured against. For a further discussion of this issue, see "Disagreement Arises Over Risk to TD Realty Trust Unit Holders," *The Globe and Mail*, Toronto, November 30, 1972.

2. Strictly speaking, a REIT could borrow directly from financial institutions if the institutions were willing to resort to their basket clauses.

An Overview of Five Canadian Reit's **Figure 16-2**

REIT	Financing Company	Owner of Financing Company	Adviser
BM-TR Realty Investments	BM-RT Ltd.	Jointly owned by Bank of Montreal and Royal Trust	BM-RT Ltd. (jointly owned by Bank of Montreal and Royal Trust)
Heitman Canadian Realty Investors	HCR Realty Ltd.	Heitman Group Ltd.	HCR Adviser Ltd. (owned by Heitman Group Ltd.)
TD Realty Investments	TDRI Ltd.	Jointly owned by Toronto-Dominion and McLeod, Young, Weir and Company	Toronto-Dominion Bank
BBC Realty Investments	BBC-RI Services Ltd.	Bank of British Columbia and BBC Realty Investors	Bank of British Columbia
GHI Mortgage Investors	None	N/A	GHI Adviser Ltd. (privately owned)

Real estate investment trusts are largely the creation of 1971 changes in the federal Income Tax Act. Section 108 (2) of the Income Tax Act exempts a trust from income tax on any earned income paid out to shareholders (this is called *conduit tax status*). Tax must be paid, however, on any earnings that are retained. Distributed income is taxable in the hands of the unit holder. Dividends received from REIT's are not subject to the dividend tax credit. The treatment of capital gains is more complex. It depends on whether all of the capital gain is transferred from the trust to the unit holder or whether the trust pays out only the taxable portion of the capital gain.

Most regulated financial institutions in Canada are subject to investment constraints which limit their ability to invest in or lend to a corporation which has an earnings or dividend record of less than five years unless they resort to a "basket clause". REIT's are trusts not corporations, but wanting to sell their debentures to financial institutions, they have had to establish shell corporations which could produce acceptable earnings or dividend records. The shell corporation is used for issuing debentures, primarily to financial institutions.[3] The funds borrowed are then loaned to the real estate investment trust.

All of the REIT's in Canada are unincorporated trusts, and consequently do not fall under the purview of any financial institution legislation. Initially, the only barriers to the activities of the trust were contained in the trust deed which created the trust and the requirements of the Income Tax Act under which the trust had to qualify as a unit trust. Subsequently, the Ontario Securities Commission (OSC) issued a policy statement on real estate investment trusts which addressed such issues as foreign ownership, minimum levels of equity capital, size of the adviser, adviser's investment in the trust, adviser fees, leverage, investment policy, and qualifications of trustees.[4]

Our primary concern here is with the restrictions on leverage and on the investment policy of the trust. Leverage was limited by OSC guidelines to three times the equity capital, retained earnings and realized capital gains of the trust; however, if NHA mortgages, conventional first mortgages, insured high ratio mortgages and cash accounted for at least 50 percent of the book value of total assets, the limit on leverage could be increased to five times the total equity capital, retained earnings and realized capital gains. With regard to investments, the trust was not permitted to invest more than 10 percent of its total assets in any one investment and the total investment in real estate could not exceed 20 percent of total assets. Real estate investments were confined to income producing property.

3. These debentures may have a variety of features to make them more marketable. For example, there may be warrants attached which are convertible into trust units or they may participate to some degree in the income of the trust. The debentures are guaranteed by the trust.

4. See Ontario Securities Commission, *Weekly Summary*, August 31, 1972 and September 7, 1972.

The Five Canadian REIT's

There are five REIT's in Canada, one of which is new and quite small. The REIT's and their relative size are seen in Table 16-1.

Total Assets of Canada's Reit's, December 31, 1973 and 1974 ($ millions) — **Table 16-1**

	1973	1974
BM-RT Realty Investments	151	195
TD Realty Investments	101	147
Heitman Canadian Realty Investors	53	78
BBC Realty Investors	43	74
GHI Mortgage Investors	—	4

Source: Annual reports of the trusts.

The first Canadian REIT, TD Realty Investments (TDRI), was created by the Toronto-Dominion Bank in September 1972. At that time, REIT's in the United States were growing rapidly and the way had been cleared in Canada for a unit trust to have conduit tax status. Bill C-209, which provided for the creation of mortgage investment companies, had been introduced into the House of Commons. However, the comparatively high residential mortgage component that would be required and the low leverage initially allowed these firms by the draft bill, influenced the Toronto-Dominion Bank to create a REIT rather than waiting to form a mortgage investment company.[5] Toronto-Dominion and McLeod, Young, Weir & Company conceived the idea of using a shell company, TDRI Limited, to provide an investment vehicle which could sell debt instruments that would be eligible under the Canadian and British Insurance Companies Act. TDRI initially raised $75 million through an issue of trust units and debentures.

The initial investments contemplated by the REIT are shown in Table 16-2. A significant proportion of the funds in this initial package were directed towards non-residential mortgage loans, construction financing and equity. Although the trust intended to eventually diversify geographically, the original investments were concentrated in Ontario.

5. For a discussion of the formation of REIT's in Canada, see J.S. Peterson, "Many Investors Are Saying 'REIT ON'!" *The Canadian Banker*, 1973.

Initial Investments TD Realty Investments
September, 1972

Table 16-2

Type of Property	Location	Nature of Investment	Investments and Commitments $ thousands	Estimated Yield* %	Maturity In Years
Investments wholly or partially funded					
Apartment Building	Sarnia, Ontario	N.H.A. Mortgage Loan	1,216	9¼	5
Apartment Building	Sudbury, Ontario	N.H.A. Mortgage Loan	913	9½	5
Single Family Dwellings	Canada	N.H.A. Mortgage Loans	4,988	9	1-5
Single Family Dwellings	Canada	Mortgage Loans	4,990	9¼	1-5
Shopping Centre	Edmonton, Alta.	Construction Loan	2,100	7½	1
Shopping Centre	Ottawa, Ontario	Construction Loan	4,400	7½	1
Land Development	Pickering Twp Ont.	Mortgage Loan	2,500	9½	4
Apartment Building	Oshawa, Ontario	N.H.A. Mortgage Loan	2,970	9	5
Industrial Building	Toronto, Ontario	Mortgage Loan	190	9½	5
Motor Inn	North Bay, Ontario	Mortgage Loan	1,122	9 7/8	6
Industrial Building	Woodstock, Ontario	Mortgage Loan	1,500	9¼	5
Apartment Building	Toronto, Ontario	Mortgage Loan	100	9½	5
Industrial Building	Toronto, Ontario	Wrap-around Loan	2,250	10¼	6
Hotel	Windsor, England	Mortgage Loan	500	9	7
Condominium Development	Palm Beach, Florida	Mortgage Loan and Real Estate Equity Investment	1,450	8	5
Total			31,189		
Commitments to Invest					
Office Building	Timmins, Ontario	Mortgage Loan	245	9¼	5
Commercial Complex	Vancouver, B.C.	Mortgage Loan	1,500	9½	5
Nursing Home	Toronto, Ontario	N H A. Mortgage Loan	1,063	9¼	5
Industrial Building	Toronto, Ontario	Mortgage Loan	225	9 3/4	5
Industrial Building	Winnipeg, Man.	Mortgage Loan	275	9¼	10
Townhouses	Ottawa, Ontario	N.H.A. Mortgage Loan	888	9¼	5
Shopping Centre	Toronto, Ontario	Construction Loan	3,500	8½	5
Hotel & Undeveloped Land	Toronto, Ontario	Mortgage Loan	1,300	8½	4
Office Warehouse	Montreal, P.Q.	Purchase Leaseback	1,100	9 1/8	13½
Industrial Building	Hamilton, Ont.	Mortgage Loan	150	9 3/4	5
Industrial Building	Toronto, Ontario	Mortgage Loan	360	9 3/4	5
Industrial Building	Pickering Twp. Ont.	Mortgage Loan	147	9 3/4	5
Total			10,753		
Grand Total			41,942		

*The weighted average yeild on the total portfolio, weighed according to the amount of the loan was estimated at approximately 8.77 percent.

Source: TD Realty Investments, *Prospectus*, September 20, 1972.

This initial portfolio mix has not been substantially altered. Table 16-3, outlining the nature of the trust's outstanding loan commitments as of December 31, 1974, indicates that the proportion of assets devoted to residential mortgages is a relatively low 31 percent. Furthermore the portfolio remains dominated by a relatively high proportion (63 percent in 1974) of investments in Ontario. The trust now makes substantial use of participation loans. As of 1974, over 17 percent of all loan commitments carried the right to bonus interest based on profits or rentals. More than any other trust, TDRI has made loans at floating rates of interest. As of 1974, 50 percent of the advanced portion and a greater proportion of the unadvanced portion of loan commitments were subject to rates of interest which ranged from 1.5 percent to 4.5 percent per annum above bank prime rates or the financing company's commercial paper borrowing cost. The result is that this trust can raise a substantial proportion of its funds on a short term basis and can maintain a reasonably consistent spread between costs and revenues in periods of fluctuating interest rates. The trust is financed through short-term notes (34 percent), medium-and long-term notes (36 percent) and equity (30 percent). TDRI Limited issued Canada's first floating rate note in October 1974, introducing further flexibility into its debt portfolio.

Loan Commitments, TD Realty Investments as of December 31, 1974 ($ thousands) **Table 16-3**

Nature of Investment	Loan Commitments: Advanced Portion	Loan Commitments: Unadvanced Portion	Total
First Mortgage Loans:			
NHA Residential	$ 23,726	$ 837	$ 24.563
Conventional residential	16,897	19,907	36,804
Industrial	17,840	925	18,765
Commercial	32,604	17,777	50.381
Land development	17,883	3,786	21,669
Junior Mortgage Loans:			
Land development	15,444	4,425	19,869
Commercial	8,807	283	9,090
Construction Loans:			
Commercial	4,685	3,702	8,387
Wrap-around Loans:			
Industrial	2,321	453	2,774
Commercial	1,073	—	1,073
Land	1,930	—	1,930
Equity Participation:			
Commercial	147	—	147
Total	$143,357	$52,095	$195,452

Source: TD Realty Investments, *Annual Report,* 1974.

BM-RT Realty Investments was created in February 1973 and, with assets of almost $200 million, is the largest REIT. The strong sponsorship (Bank of Montreal and Royal Trust) along with a conservative investment policy make this one of the blue chip REIT's. As seen in Tables 16-4 and 16-5, it is clear that this REIT is accumulating a portfolio of residential mortgages distributed over a wide geographical area. The declared investment policy of this trust is to invest at least 80 percent of its assets in conventional first mortgage loans, NHA mortgage loans, cash and government securities with the remainder to be invested in purchase leasebacks, real estate equity and other mortgage loans.

With its conservative investment policy, this trust has been able to achieve a high degree of leverage. As of December 31, 1974, capital was derived from short-term notes (2 percent), notes due in four years (51 percent), notes due in nine years (26 percent) and trust units (21 percent).

Pro Forma Investments of BM-RT Realty Investments, March 12, 1975* — **Table 16-4**

Type of Property	Number of Loans	Total Amount in $ millions	Average Amount in $
Single Family Dwellings	9,626	204.9	21,284
Duplexes and Small Apartment Buildings	672	37.1	55,275
Total	10,298	242.0	23,502

* These data include commitments made as of March 12, 1975 and subject to the issue of almost $40 million in debentures and $12 million in trust units that were offered in March 1975.

Source: Dominion Securities Corporation Harris & Partners Limited, *BM-RT Ltd. and BM-RT Realty Investments Offering Prospectus,* March 12, 1975.

Pro-Forma Geographical Distribution of the Loans of BM-RT Realty Investments, March 12 1975* — **Table 16-5**

Geographical Distributiuon	Number of Loans	Total Amount in $ Millions	Average Amount in $
Atlantic Provinces	897	19,932	22,221
Quebec	1,619	32,052	19,797
Ontario	3,870	91,539	23,653
Prairie Provinces	1,183	31,131	26,315
British Columbia	2,729	67,372	24,687
Total	10,298	$242,026	$23,502

* These data include commitments made as of March 12, 1975 and subject to the successful issue of almost $40 million in debentures and $12 million in trust units offered in March 1975.

Source: Dominion Securities Corporation Harris & Partners Limited, *BM-RT Ltd. and BM-RT Realty Investments Offering Prospectuses,* March 12, 1975.

BBC Realty Investors was established in British Columbia in November 1972 under the sponsorship of the Bank of British Columbia. The trust intends to place its funds in a diversified portfolio of real estate related investments with the majority of loans secured by first mortgages. As seen in Table 16-6, the trust has substantial holdings of residential mortgages plus a variety of commercial, industrial and interim loans. More recently, the trust has sought participation interests in a number of loans. Consistent with the portfolio of the sponsor, investments are concentrated in western Canada.[6]

Percent Distribution of the Portfolio of BBC Realty Investors, 1973 and 1974 — **Table 16-6**

Type of Loan	1973	1974
Residential	48.7	42.8
Development	13.6	19.7
Construction	4.3	14.4
Industrial	10.4	9.4
Commercial	17.1	8.9
Junior and Wrap-Around	5.9	4.8
Total	100.0	100.0

Source: BBC Realty Investors, *Annual Report,* 1974.

Heitman Canadian Realty Investors[7] (HCRI) was the fourth REIT established in Canada and the only one sponsored by foreign interests. The adviser, HCR Adviser Ltd., is wholly owned by the Heitman Group Incorporated which engages in mortgage banking and advises a REIT in the United States. HCRI investment policies are more aggressive than other REIT's as they are seeking to specialize in large dollar loans for construction and development and are thus avoiding mortgages on single family properties.[8] Table 16-7 outlines the investment portfolio of HCRI as of December 31, 1974. Table 16-8 indicates that the bulk of loans are in Ontario, Quebec and British Columbia, with this REIT investing in Quebec somewhat more than other REIT's have. Table 16-9 confirms the relatively low proportion of loans devoted to residential properties. It has raised its funds through bank loans (32 percent), long-term notes (33 percent) and trust units (35 percent).

6. For a discussion of BBC Realty, see "BBC REIT – Born in the West and There It Plans to Stay," *The Financial Post*, Toronto, December 2, 1973.

7. For a comprehensive study of the mortgage market in general and the Heitman REIT in particular, see *Information Memorandum on Heitman Canadian Realty Investors and HCR Realty Ltd.*, Toronto: Nesbitt, Thomson & Company Ltd., March 5, 1973.

8. See "New REIT Wants Major Projects," *The Financial Post*, Toronto, May 12, 1973.

Investment Portfolio, Heitman Canadian Realty Investors, December 31, 1974 — Table 16-7

Type of Commitment	Amount Advanced	Unfunded Commitments	Total
Construction loans and progress payments	$ 8,649,263	$ 25,670,000	$ 34,319,361
Other first mortgage loans:			
Short -term	1,000,000	—	1,000,000
Intermediate term	29,017,218	3,017,500	32,034,718
Long-term	29,961,010	2,200,000	32,161,010
Land development	2,540,844	179,156	2,720,000
Junior mortgage	3,883,439	542,841	4,426,280
Stand-by and gap commitments	—	11,650,000	11,650,000
Total	$75,051,774	$43,259,595	$118,311,369

Source: Heitman Canadian Realty Investors, *Annual Report,* 1974.

Investment Commitments of Heitman Canadian Realty Investors by Geographical Location, December 31, 1973 and 1974. — Table 16-8

	1973		1974	
Geographical Location	Amount	Percent	Amount	Percent
Quebec	$ 33,699,110	39.6	$ 44,729,408	37.8
Ontario	30,704,464	36.1	36,829,219	31.1
British Columbia	11,474,400	13.5	20,614,925	17.5
United States	—	—	6,650,000	5.6
Nova Scotia	—	—	4,250,000	3.6
Saskatchewan	3,600,000	4.2	3,591,592	3.0
Manitoba	2,600,000	3.0	700,000	0.6
England	600,000	0.7	598,517	0.5
Alberta	2,475,992	2.9	347,708	0.3
Total	$85,153,966	100.0	$118,311,369	100.0

Source: Heitman Canadian Realty Investors, *Annual Report,* 1974.

GHI Mortgage Investors, created in Manitoba in March 1974, is the newest and by far the smallest REIT in Canada. GHI Adviser Ltd., on an agency basis, has publicly sold over $3 million of trust units and the units are sold on the Winnipeg Stock Exchange. The $1,000 per unit price reflects the fact that the initial investors were persons who had substantial sums of money available for investment in the junior mortgage market. Once an earnings record was established, it was intended to split the units prior to another financing via a national underwriting. GHI Adviser Ltd., which is controlled by Genevieve Holdings Ltd., will act as the adviser and present investment opportunities to the trust.[9]

9. For additional information on GHI Advisor Limited, see "Mortgage Banking Firm Formed," *The Globe and Mail*, Toronto, April 17, 1974.

Investment Commitment of Heitman Canadian Realty Investors by Type of Property, December 31, 1973 and 1974. **Table 16-9**

Type of Property	1973 Amount	1973 Percent	1974 Amount	1974 Percent
Commercial & Shopping Centres	$ 23,600,000	27.7	$ 43,811,890	37.0
Office	12,162,150	14.3	23,423,517	19.8
Industrial Parks & Buildings	23,159,953	27.2	22,721,180	19.2
Hotels	9,476,703	11.1	13,140,144	11.1
Apartment Projects	12,080,160	14.2	10,539,638	8.9
Condominium Projects	4,675,000	5.5	4,675,000	4.0
Total	$85,153,966	100.0	$118,311,369	100.0

Source: Heitman Canadian Realty Investors, *Annual Report,* 1974.

Although GHI Mortgage Investors qualifies as a unit trust under the Income Tax Act it has as yet no shell company with which to qualify debt instruments as eligible investments under the Canadian and British Insurance Company Act. Compared to other REIT's we have discussed, this trust has weaker sponsorship, although the principals in the adviser have been successful in this lending area for many years. In general, the trust intends to seek higher yielding interim mortgage loans but not to take an equity position in any real estate. Table 16-10 outlines the initial investments proposed for the firm at the time of its creation. Because of the initial small size of the asset base of the trust, most loans are participations with another lender in order to achieve some diversification. One can also see an emphasis on loans in western Canada. Table 16-11 summarizes the portfolio holdings as of December 31, 1974.

Although it may be premature to draw firm conclusions about individual REIT asset and liability management, some patterns are emerging. In most cases, the geographical distribution of initial and subsequent loans have mirrored the geographical strengths of the advisers. The emphasis on residential mortgages varies widely and except for BM-RT, all REIT's are active in a variety of interim lending arrangements. Most REIT's have shown a propensity for participation and floating rate loans. The trusts have utilized their substantial bank lines of credit and, in some cases, issued short-term notes to finance their operations. All of the REIT's hold a portfolio which permits them the maximum leverage ratio of 5:1 but none have yet reached that limit.

Anticipated Initial Investments, GHI Mortgage Investors, March 1974 **Table 16-10**

Location and Type of Property	Type of Loan	Maturity date (Subject to Borrowers Rights to Prepay)	Estimated Annual Yield on Loan (1)	Total Principal Amount of Loan ($ thousands)	Amount of Trust's Participation (at par) (2) ($ thousands)
Calgary, Alberta Nursing Home	Secondary Financing	December, 1976	15%	190	100
Campbell River, B.C. Hotel	Secondary Financing	March, 1977	16.5%	80	40
Calgary, Alberta Improved Land	Development Loan	December, 1975	51/2% over bank prime (3)	253	100
Calgary, Alberta Retail Building	Secondary Financing	September, 1976	6% over (3) lenders' prime	200	100
Fort McMurray, Alberta Apartment Building	Construction Loan (4)	June, 1974	6% over bank prime (3)	161	75
Kamloops, B.C. Unimproved Land	Development Loan	July, 1978	6% over (3) lenders' prime	750	100
Yorkton, Sask. Shopping Centre	Secondary Financing	August, 1976	12%	195	85
Edmonton, Alberta Apartment Building	Wrap-around loan	December 1978	14%	553	100
Winnipeg, Manitoba Hotel	Wrap-around loan	August,1976	14%	667	100
White Horse Yukon Territory Apartment Building	Construction loan(4)	August, 1974	6% over (3) lenders' prime	500	100
Vancouver B.C.	Wrap-around	September, 1976	12%	622	100
Total				$4,171	$1,000

(1) The weighted average yield on the initial portfolio as at February 28, 1974 is approximately 14.64%.
(2) Each loan is a participation with Genevieve Holdings Ltd. or an Affiliate thereof.
(3) The minimum interest rate is 13% per annum.
(4) To be retired out of the proceeds of long-term mortgages arranged by the borrowers.

Source: GHI Mortgage Investors, *Offering Perspectus,* March 1974.

Investment Portfolio of GHI Mortgage Investors as of December 31, 1974 — **Table 16-11**

Nature of Investment	Amount	Estimated Weighted Average Annual Yield (%)	Percentage of Portfolio
First mortgage loans		15.06	11
Commercial	$ 400,000		
Second mortgage loans		15.98	47
Commercial	1,533,923		
Development	250,000		
Construction loans		16.92	31
Commercial	975,000		
Residential	226,935		
Wrap-around loans		13.25	11
Commercial	421,806		
TOTAL	$3,807,664	15.88	100

Source: GHI Mortgage Investors, *Annual Report,* 1974.

The Future of REIT's

The future growth and viability of REIT's depends on a number of factors including the demand for real estate financing, investor acceptance of REIT equity and debt securities and competition from other lenders.

The demand for mortgage funds is discussed in detail in Chapter 2. There appears to be a concensus that demand will remain high for a number of years and that vehicles such as REIT's will be needed to meet the shortfall in available funds.[10] Perhaps the key to the success of any REIT is the ability of its sponsors to generate an adequate number of appropriate loans. The four largest REIT's all have strong sponsors who provide expertise and financial backing when necessary. REIT's may have a comparative advantage in that they can provide a complete package of financing for major developers, a strength some of their competitors do not have. In addition, insurance companies, trust companies and banks cannot rely heavily on the bond market to provide financing while REIT's can.[11]

Profitability of individual REIT's will depend on the degree to which they successfully lever their earnings through the issue of debt. Of course, the viability of a REIT depends on the maintenance of a spread between borrowing rates and rates available on real estate related loans. Any structural changes in these relative yields due to legislation, major changes in economic conditions or new insti-

10. For a discussion of this anticipated shortfall, see *The Canadian Mortgage Market*, Toronto: McLeod, Young, Weir & Company, January 13, 1973.

11. At the time of writing, this can be questioned in that REIT's, particularly those in the United States, are having difficulty in their attempts to issue both debt and equity.

tutions could adversely affect REIT's. Tight money, developer bankruptcies and narrowing spreads have caused severe problems for many REIT's in the United States[12] but these conditions are not expected to adversely affect the more conservatively managed Canadian REIT's.[13] Investor acceptance of REIT's has been quite good. A REIT provides an opportunity of acquiring a liquid, relatively high yielding, and secure investment in the real estate market.[14]

MORTGAGE INVESTMENT COMPANIES

On December 7, 1973, the House of Commons passed Bill C-135 (The Residential Mortgage Financing Act). In addition to an act creating the Federal Mortgage Exchange Corporation, this bill provided amendments to the Loan Companies Act permitting the creation of mortgage investment companies and amendments to the Income Tax Act stipulating the tax status of these mortgage investment companies. This section deals with mortgage investment companies.

The Regulation of Mortgage Investment Companies (MIC's)

A MIC is generally subject to the provisions of the federal Loan Companies Act and must meet additional constraints in areas such as leverage, investment powers and tax status. A MIC is authorized to issue shares and borrow funds. Like REIT's, however, the degree of leverage allowed is tied to the nature of the firm's investments. Borrowing may be up to five times the excess of the book value of assets over liabilities as long as investments in residential mortgages, cash or equivalent are at least two-thirds of total assets. The permitted debt ratio falls to three times if the proportion of residential mortgages and cash falls below two-thirds of total assets.

The debentures and shares issued by MIC's are eligible investments under the Canadian and British and Foreign Insurance Company Acts as well as being eligible investments for guaranteed funds held by federal trust companies. MIC's are not permitted to accept deposits, but debentures issued which do not exceed five years in term may be insured up to a value of $20,000 per depositor by the Canadian Deposit Insurance Corporation.

A MIC is not permitted to have less than 20 shareholders and no more shareholder may hold more than 25 percent of the issued shares. If a trust governed by a registered pension plan or deferred profit sharing plan purchases the shares, it is counted as four shareholders whereas a trust governed by a registered retirement savings plan is counted as one shareholder. Thus, five or more pension

12. See "New Laws for the Once Mighty REIT's," *Business Week*, April 20, 1974.

13. See "REIT's Not Expected to Face Liquidity Problems of U.S. Counterparts," *The Globe and Mail*, Toronto, July 4, 1974.

14. For an investment appraisal of the four public REIT's, see J.B.F. Cripps, *Basic Report, Canadian Real Estate Investment Trusts*, Toronto: Wood Gundy, April 1975.

plans can jointly create their own MIC. Holders or preferred shares must be permitted to participate "pari passu" in any dividends paid after the preferred and common shareholders have each received initial dividends in like amount.

There are a number of additional restrictions on MIC investment powers. At least 50 percent of the book value of assets must be invested in residential mortgages, deposits or cash and no more than 25 percent of assets may be invested in real property. Investments in real estate may only be made for the purpose of producing income and only if the property has yielded a reasonable return in the past three years or if the property is leased to, or the rentals guaranteed by, government or certain other qualifying corporations. In general, the firm may only invest funds, it may not manage or develop any real property. Similar to other legislation governing financial institutions, there is a basket clause which permits up to seven percent of the book value of assets to be placed in investments not otherwise authorized. All real estate investments, however, must be for income generating purposes.

There must be a minimum level of liquidity. Current assets made up of principal repayments on mortgages due within one year, other maturing investments, credits from chartered banks and cash or deposits must be greater than all debt expected to mature within one year and all mortgage commitments for the coming year. This requirement is notwithstanding any liquidity requirements to which loan companies are already subject.

MIC's and Taxation

Amendments to the Income Tax Act allow the income of MIC's, under certain circumstances, to flow through to the shareholder free of corporate tax. In particular, the MIC may, in computing its taxes, deduct from income all taxable dividends paid during the year or within 90 days after the end of the year and may deduct half of all capital gains dividends paid. In the hands of a shareholder, a dividend which is not a capital gains dividend is deemed to have been received as interest payable on a bond. Any capital gains dividends are taxed in the same way as a capital gain on the sale of property.

Government Objectives of MIC's

The creation of MIC's was one of several steps promoted by the government to attack housing problems. The objective was to increase the flow of private funds into the mortgage market, thus leaving government capital free to be directed to such areas as low income housing and land banking. Although it was hoped that more funds would be supplied for mortgages and interest rates on mortgages relative to other debt would fall, it was not considered possible to quantify the expected impact of MIC's in these two areas.

MIC's were intended to remove three barriers to the supply of funds to the mortgage market by smaller investors. The barriers, as indicated by the Ho-

nourable Mr. S.R. Basford, were (1) the difficulty of dividing mortgages into shares so that smaller investors could participate, (2) the large sums of money required to achieve diversification, and (3) the unfamiliarity of potential investors with the mortgage market.[15] MIC's circumvent these barriers by providing expertise and an opportunity to invest small amounts in a diversified real estate and mortgage portfolio. Conduit tax status treats the shareholder as if he had invested in the portfolio directly, a status roughly parallel to that of mutual fund trusts. While the legislation forces a certain level of investment in mortgages, MIC's are permitted some equity and real estate investments in order to provide a more attractive portfolio for investors.

Creation of the First MIC

Arteco Mortgage Investment Company was formed by Royal Trust in January 1974 and in March 1974 became the first MIC to attempt a public offering.[17] The debenture and common share issue which was anticipated to total $65 million was subsequently withdrawn due to "unsettled financial markets."[18]

At the time of the attempted Arteco issue, Fidmor Mortgage Investors Corporation had filed prospectuses with the Ontario Securities Commission for two separate issues, one for debentures and another for shares. Faced with the withdrawal of Arteco and a rapidly declining bond market, Fidmor decided to postpone its attempt to go public. Fidmor was sponsored by Fidmor Advisors Corporation which was owned 40 percent by First Hamilton Corporation, 30 percent Fidelity Mortgage and Savings Corporation, with the remaining funds provided by a trust company and a number of pension funds.[19] The firm expected to make construction development, bridge, wrap-around and first mortgage loans. The proposed initial investment portfolio is seen in Table 16-12. There was to be a heavy emphasis on the Toronto-Hamilton area which is consistent with the sponsor's area of operation.

Morguard Mortgage Investment Company of Canada (MMICC) became Canada's first successfully launched mortgage investment corporation in July of 1974 with the private placement of a combined common and preferred share issue

15. The Honourable S.R. Basford in *HANSARD*, 1st Session, 29th Parliament, Vol. V, June 12, 1973, p. 4686. Mr. Basford noted the existence of four newly formed Real Estate Investment Trusts (REIT's) whose impact on the mortgage market was expected to be somewhat the same as the impact of MIC's. However, he suggested that MIC's were a simpler investment vehicle and would be under federal legislation whereas REIT's operated under provincial trust laws and securities act regulations.[16]

16. *Ibid.*, pp. 4686-4687.

17. "Introducing the New MIC's, Close Cousins of the REIT's," *The Financial Post*, Toronto, March 23, 1974.

18. "Markets Frighten First MIC," *Financial Times*, Montreal, April 1, 1974.

19. Other owners of Fidmor Advisors included 10 percent by the Equitable Trust Company and five percent each by the pension funds of Bell Canada, Canada Packers, Dominion Foundries and Steel and the T. Eaton Company Ltd.

totalling $20 million.[20] This MIC is sponsored and managed by Morguard Trust which holds 2 1/2 percent of the equity. The Air Canada Pension Fund and Canadian National Railway Pension Fund each hold 25 percent of the equity while the Alberta Teachers Retirement Fund and Alberta Government Telephones each hold 12 1/2 percent.[21] The success of MMICC following the difficulties of other proposed MIC's is related to two factors. First, no debt was issued, thus avoiding the uncertainties of the debt market and second, the equity issue was privately placed with a small number of investors.[22] It is intended that this founding group will retain control and should equity issues be necessary in the future, additional preferred shares will be issued. Initial debt financing will

Fidmor Mortgage Investors Corporation, Proposed Initial Investment Portfolio, March 1974 — **Table 16-12**

Location of Property	Type of Property	Type of Loan	Term of Loan (years)	Estimated Yield on Loan (%)	Total Principal Amount of Loan	Total Corporation's Portion of Loan
Mississauga, Ontario	57 Single Family Dwellings	Medium-Term First Mortgage Loans; MICC Insured	5	10¼	2,703,920	2,703,290
Mississauga, Ontario	198 Apartment Condominiums	Short-Term First Mortgage Construction Loan; MICC Insured	2	11¼	3,783,641	3,783,641
Etobicoke, Ontario	150 Stacked Townhouse Condominiums	Medium-Term First Mortgage Loans; NHAand or MICC Insured	5	10½	5,302,500	3,976,875
Etobicoke , Ontario	150 Stacked Townhouse Condominiums	Medium-Term First Mortgage Loans; NHA and/ or MICC Insured	5	10½	5,302,500	3,976,875
Burlington, Ontario	4 Office Buildings	Medium-Term First Mortgage Loan	5	10½	754,000	754,000
Stayner, Ontario	10 One-bedroom Apartment and 2 commercial areas.	Medium-Term First Mortgage Loan	5	10¼	166,500	166,500
Brantford, Ontario	11Three-bed-room townhouses	Medium-Term First Mortgage Loan	5	10¼	190,000	190,000
Hamilton, Ontario	60-bed Nursing Home	Medium-Term First Mortgage Loan; NHA insured	5	10½	607,000	607,500

Source: Fidmor Mortgage Investors Corporation, *Preliminary Prospectus,* March 15, 1974.

20. See "This MIC, At Least, Looks Well and Truly Airborne," *The Financial Post*, Toronto, July 27, 1974.

21. Other shareholders include Canadian Industries Limited Pension Fund, City of Ottawa Superannuation Fund, Saskatchewan Wheat Pool Retirement Fund, Co-operative Life Insurance Co. and Co-operative Superannuation Society.

22. See "Mortgage Investment Company Established by Morguard Trust," *The Globe and Mail,* Toronto, July 18, 1974.

take the form of bank loans, debentures and short-term money market securities. Debentures will not exceed $20,000 each and will have terms not exceeding five years so that they may be insured by the Canada Deposit Insurance Corporation. In order to qualify for maximum borrowing power, the firm is investing in excess of two-thirds of its portfolio in mortgages on residential property. As of May 15, 1975, advanced and unadvanced mortgage commitments totalled approximately $30 million.

Seel Mortgage Investment Corporation was incorporated under the Loan Companies Act of Canada in October 1974 and was licensed to operate as a loan company in December 1974. The firm was sponsored by Seel Enterprises, an originator of commercial and residential mortgages. The Seel MIC has actively sold debentures insured by the Canada Deposit Insurance Corporation.

In March 1975, Arteco returned to the market with a $15 million debenture issue and a new issue of $4 million in shares. Both the debentures and shares were placed privately, primarily with institutional investors. Arteco initially invested all of its funds in geographically diversified residential mortgage loans and intends to invest at least two-thirds of its portfolio in this way to achieve the maximum permitted leverage. Royal Trust administers the firm and provides it with investment opportunities.

As of May 1975 at least one more MIC, Bomont Mortgage Investment Company, was in an advanced stage of formation.

COMPARISON OF MIC'S AND REIT'S[23]

MIC's and REIT's are similar in that they both are vehicles for obtaining additional funds which may be placed in real estate related investments and they both have conduit status for tax purposes. There are, however, several important differences between them. REIT's are constrained by the Income Tax Act, the trust indenture creating the REIT, and the regulations set down by the securities commissions under whose jurisdiction trust units and debentures are issued to the public. MIC's are subject to the Income Tax Act and Part II of the Loan Companies Act as well as any securities legislation applicable to the distribution of their securities.

MIC's are supervised by the Superintendent of Insurance as are other federal trust and loan companies. MIC's may also be incorporated provincially with the passage of enabling legislation. REIT's are not subject to this type of supervision.

Both MIC's and REIT's are permitted to borrow but the first $20,000 per person of any debenture with maturity less than five years issued by a MIC is insurable

23. For a brief but readable comparison of MIC's and REIT's and a discussion of Bill C-135, see Canadian Real Estate Association, *MICS and the Canadian Real Estate Industry*, September 1973. See also "The Mortgage Investment Company," *Canadian Mortgage Market Review*, August 1974.

by the Canada Deposit Insurance Corporation. This is not true for a REIT. The shares and debt issued by MIC's are eligible investments under the Canadian and British and Foreign Insurance Company Acts, the Trust Companies Act and the Loan Companies Act. Units of REIT's are not eligible investments although the debentures of the REIT's have been made eligible through the use of shell companies. Investment in REIT units, however, may be made under the basket clause governing financial institutions. Since MIC's are corporations, shareholders have limited liability whereas unit holders of REIT's do not. MIC's have an advantage in that their minimum equity capital requirement is $500,000 ($1 million in Ontario), while the minimum for REIT's is $5 million and the adviser must have a net worth of at least $2 million and must invest in the REIT.[24]

With regard to leverage, both the MIC and the REIT are allowed a ratio of debt to equity of 3:1. For REIT's, this ratio may be raised up to 5:1 if at least 50 percent of the book value of assets consists of NHA mortgages, conventional (up to 75 percent of value) first mortgages, high ratio mortgages, cash and government securities. MIC's may increase this ratio to 5:1 if two-thirds of the book value of assets is invested in mortgages on residential property, cash or approved deposits. The result of this difference is that MIC's should be more oriented to residential mortgages than REIT's.

Both MIC's and REIT's are permitted to invest in only income producing properties; real estate investments by MIC's are limited to 25 percent of assets, while by REIT's they are limited to a maximum of 20 percent of the book value of total assets. There is no specific residential component required in the REIT portfolio but MIC's must invest at least 50 percent of the book value of their assets in residential mortgages and cash.

24. This is the Ontario Securities Commission regulation pertaining to REIT's. Other provinces allow a lower minimum level of capital as evidenced by BBC Realty and GHI Mortgage Investors.

Chapter 17

The Client and Secondary Mortgage Markets

Mortgage transactions may be categorized as primary or secondary. The *primary market* is one in which new mortgages are created. This market may be further subdivided into "in-house" and "client" transactions. An *in-house transaction* is one in which a firm originates a mortgage for its own portfolio, while a *client transaction* is one in which a firm originates new mortgages for some other entity. The *secondary market* is where existing mortgages are traded but no new mortgages are created.

In the mortgage industry, it is common to hear both client and secondary market transactions referred to as secondary market activity. There is a significant difference between the two, however, and we will maintain the distinction in this chapter.

The objective of this chapter is to outline the nature of the client and secondary markets in Canada. An examination of why such markets are needed, the participants in these markets, some of the barriers inhibiting their operations, and efforts by the Federal government to promote these markets will be discussed.

THE PURCHASE AND SALE OF MORTGAGES

The Client Mortgage Market

If all institutions wanting to invest their funds in mortgages were able to originate all of their own mortgages, there would be no need for one firm to originate for another. However, it is clear that there are a large number of institutions that do not have the required originating facilities. This situation is likely to become more pronounced as savings patterns within society shift from the traditional deposit seeking institutions to pension plans and specialized investment funds.

As indicated in Figure 17-1, mortgages may be originated on a client basis for at least four types of investors.

Some financial institutions originate mortgages for captives. For example, the Royal Bank originates all of the mortgages for their wholly owned subsidiary

Roymor Limited and the Bank of Montreal originates all of the mortgages required by their subsidiary, First Canadian Investments Limited. Several institutions sell units in mortgage funds. These funds are typically supplied with mortgages by their sponsors. For example, Royal Trust originates the mortgages held by the Royal Trust "M" Fund.

Mortgage Origination Categorized by Ultimate Investor — **Figure 17-1**

A. Primary Market (origination of new mortgage loans)

I. In-house Origination
II. Client Origination for:
. a captive
. an affiliate
. an arms-length client
. speculative sale

B. Secondary Market (trading of existing mortgage loans)

One type of origination activity which will become increasingly common in the future is the origination of mortgages for an affiliate. Most real estate investment trusts (REIT's) that entered the market were dependent on the originating facilities of one or more of their sponsors. For example, the Bank of Montreal and Royal Trust share the origination of mortgages for BM-RT Realty Investments. The new mortgage investment companies (MIC's) also require the services of an originator. For example, Morguard Trust Company originates the mortgages required by Morguard Mortgage Investment Company of Canada.

A number of institutions originate mortgages for clients on an agency basis or against a takeout commitment when funds are fully advanced. The originators have several types of clients. Non-Canadian life insurance companies frequently lack origination facilities as do some of the smaller insurance companies. Pension funds are also large potential customers. A typical originator-investor relationship exists between Metropolitan Life and two Canadian trust companies. Metropolitan Life does not have any Canadian origination facilities of their own and have appointed Montreal Trust and Morguard Trust as mortgage correspondents. Metropolitan indicates its needs in advance and the two correspondents attempt to fill them for a fee.[1] Clients usually specify their requirements for at least a year in advance. Although the originator will hold the mortgage in its inventory on behalf of the client while advances are occuring or between the time of commitment and the time of takeout by the investor, there is little inventory risk involved.

1 For a further discussion of this arrangement, see "The Met Looks For More Action In Mortgage Hunt," *The Financial Post*, Toronto, December 23, 1972.

A final type of activity to be considered is the speculative origination of mortgages. This implies that the mortgages will ultimately be sold but the originating institution does not, at the time of origination, know to whom. Some firms have toyed with the idea of holding an inventory of fully advanced mortgages. For example, one institution indicated that it pre-processed mortgages by 30 to 90 days so as to make them available in convenient form when the client was ready to make a commitment. This, however, requires a prior knowledge of what a potential client's needs will be. There is evidence that some firms occasionally hold a small inventory of mortgages. One trust company suggested that it was willing to build up an inventory of mortgages of 10 to 20 million; however, this is normally done only when the prospects for resale of the mortgages look particularly good. At least one investment dealer indicated that it had occasionally held an inventory of mortgages, but it was for a short period. Under present Ontario Securities Commission capital requirements, an investment dealer making a commitment against a mortgage would have to have funds available to cover the commitment, although the funds may not be needed for some time. Consequently, it is quite difficult for a dealer to pre-commit.

The Secondary Mortgage Market

Ideally, a secondary mortgage market exists when there are active buyers and sellers of fully advanced mortgages and when there is a reasonable information network linking the two. One would expect to find some institutions actively bringing buyers and sellers together in return for a commmission. Other institutions add to the liquidity of the market by standing ready to purchase or sell mortgages out of inventory.

Within the above framework, there was a fledgling secondary mortgage market in Canada in 1975. A number of institutions in the market purchased mortgages and several others regularly offered mortgages for sale. The information network between buyers and sellers left something to be desired since there was no central market place where quotes could be obtained. A variety of firms were actively attempting to bring buyers and sellers together but the process was somewhat cumbersome. Although some firms carried a small inventory, it was primarily for selling purposes and was increased by new originations rather than open market purchases. Most institutions continued to represent themselves as either originators or investors but not mortgage traders. The originators created mortgages for their own portfolio and were willing to sell any excess, whereas investors purchased mortgages as a buy-and-hold investment.

In 1974 and 1975, a variety of more sophisticated mortgage trades began to occur. In some cases, investors sold takeout commitments with a fixed interest rate at a profit. There was some indication that investors were increasingly willing to treat mortgages as tradeable securities. One pension fund, feeling that the yield on mortgages was more attractive, sold bonds from its portfolio using the funds to purchase a package of mortgages. Another pension fund, wishing to shorten the term of its portfolio, sold a 20 year rental mortgage and purchased a package of five year term mortgages through the same agent.

Reasons for Buying Fully Advanced Mortgages

As discussed earlier, several institutions purchase mortgages in the primary market by having mortgages originated to their specifications. For a number of reasons, institutions may wish to purchase fully advanced mortgages in a secondary market instead.

The origination of a mortgage is frequently a long and uncertain process; on a rental property it can take two years. All financial institutions attempt to forecast their inflows of funds as accurately as possible. Based on these forecasts, the portfolio manager attempts to match fund inflows with fund outflows. When the timing of the fund inflows does not match that of the takedown of mortgage funds, the manager must decide where the funds should be temporarily placed. This could result in a sub-optimal use of funds. Thus, the investor may simply purchase existing mortgages as funds become available.

While the forecasting of funds inflows is less difficult for some institutions, such as pension funds, others cannot make accurate long run forecasts. These firms may sometimes have funds in excess of either future commitments or the firm's short run mortgage origination capability. In addition, a number of investors are only occasional purchasers of mortgages. For example, foreign insurance companies and trusts have all acquired Canadian mortgages. This results in a variety of domestic and foreign firms sporadically entering the market to purchase fully advanced mortgages.

A final reason for the purchase of existing mortgages is the desire to diversify. An investor who feels that it has placed too high a proportion of its funds in one type of mortgage or geographical region may seek a diversified package of mortgages from the portfolio of a financial institution.

Reasons For Selling Fully Advanced Mortgages

Institutions are willing to sell mortgages from their portfolios for a number of reasons. Three of the most common are the attractiveness of alternative investments, the possibility of earning an origination or servicing fee and liquidity requirements.

An institution may purchase a mortgage with the intention of holding it until maturity but be willing to sell if the funds can be reinvested at a higher rate of return. Of course, if the funds cannot be quickly reinvested, some of the advantage of the transaction is lost.

There is usually a fee for origination and servicing of mortgages. Since servicing is a profitable activity and if an institution can retain the servicing of the mortgages that it sells, it is in the interest of an institution to originate mortgages and resell them. Chartered banks and trust companies are the most active firms in this area. Several of the banks indicated that they intend to become even more active particularly in an attempt to cultivate the pension fund market.

A third reason for selling mortgages is the need for liquidity. Financial institutions have a number of legal or internal liquidity requirements. If a chartered bank or trust company makes a number of advance commitments and a period of tight money occurs, the institution may be forced to sell some of the mortgages from the existing portfolio to meet its commitments. In the case of banks, one alternative is to sell these mortgages to a captive. For example, the Toronto-Dominion Bank may sell its excess mortgages to Tordom Corporation who, in turn, would issue short to intermediate term paper to finance the purchases. If the captive is unable to absorb all of the excess mortgages, it may sell its mortgages in the open market. A case in point may be the sale in 1973 of a sizeable amount of mortgages by Kinross Mortgage Corporation.

Packaging Mortgages For Sale

Since mortgages are originated individually, if a request for a block of mortgages is received they must be packaged for the customer. One approach is to have a complete record of the lender's mortgage holdings stored in the head office computer. When there is a request, the buyer's preferences are programmed into the computer and a suitable package is assembled. The local branch servicing the mortgage may not be told that they have been sold. Some institutions keep their mortgage records at local branches and must make an inquiry to determine if the branches have the types of mortgages requested.

A variety of mortgages are available in the secondary market but NHA insured mortgages on single family homes are the most common. These loans are preferred because they are all government insured, and are of similar type and quality. With the rapid growth of private mortgage insurance company activities, privately insured mortgages should become increasingly acceptable as well. Blocks of single family mortgages are preferred to larger mortgages because a credit check can be conducted with relative ease and the investor can easily obtain geographical diversification. Although the investor may specify a particular geographical location, this choice is normally made by the lender. Because of the recent rise in interest rates, the five year term of single family mortgages is more attractive, although some old NHA mortgages with longer terms are also available. Packages of single family mortgages normally have the same maturity date and interest rate. Perhaps the easiest package to sell is a block of NHA insured mortgages in a metropolitan area.

Apartment building mortgages are larger in size than those for single family houses. For example, a 250 unit apartment building mortgage may be valued at $4.5 million. The term on this type of mortgage is usually from 15 to 25 years. Because of the large size of these mortgages and the extended maturities, they have greater appeal for large, long-term investing, financial institutions such as insurance companies and pension funds. In some cases, the selling firm syndicates the mortgage, selling it to a group of smaller institutions or investors. The purchase of a mortgage on a rental property generally requires a higher degree of skill than the purchase of a mortgage on a single family property. For a rental

mortgage, all existing information on the property has to be updated if the mortgage is sold. The large size and the lack of uniformity of apartment mortgages makes them less attractive than house mortgages in the secondary market. It is interesting to note that a buyer of a mortgage in the secondary market may find that the information he requires is more readily available from the institution that initially originated the mortgage. Therefore, an institution may be able to operate in a secondary market for its own placements more easily than in the secondary market in general.

There is a short supply of prime commercial mortgages. An example of a prime commercial mortgage is a free standing store, subject to a Simpsons-Sears' lease, sufficient to pay off 85 percent of the original mortgage by the end of the term of the lease.

When mortgages are sold, a sale and an administration agreement is signed. The *sale agreement* lists the mortgages purchased and details of the purchase including the price, date of purchase, servicing charges and the timing of payments. The *administration agreement* specifies the rights and duties of both the vendor and purchaser. The vendor, if he continues to service the mortgages, is responsible for all collections and for ensuring that normal activities such as tax and insurance payments are undertaken. The vendor normally acts on behalf of the purchaser if the mortgage is defaulted, but the risk of loss of principal and interest rests with the purchaser.

Mortgages, including NHA mortgages, are not particularly standardized. Although certain minimum standards are usually maintained, these vary from one financial institution to another. The individual home purchasers and the quality of their properties vary as well. The sale and administration agreements discussed earlier differ from one firm to another. Some vendors guarantee their mortgages against loss or against repayment for the first few years while others do not.

Some financial institutions add additional maturity features to the packages of mortgages that they sell in the secondary market. For example, a bank that sells packages of conventional mortgages indicated that its mortgages are closed (i.e., non-repayable) for the first year and open thereafter, only if paid in full and only if accompanied by a three month interest penalty on prepayment. However, the mortgages could be repaid up to 10 percent of the principal amount at the second and each subsequent anniversary. This bank undertook to replace for the investor any mortgage which was paid in full within the first three years. One investment dealer, who sells five year term NHA mortgages, suggested to its customers that it be notified six months in advance of the end of the term whether the investor intended to renew the loan. Investors were also warned that "under extreme economic conditions it may be possible that negotiations with mortgagors may extend past the maturity date of the mortgages and result in delay in retaining the principal outstanding".[2] This implied that, if the lender wanted, to remain

2 See Midland-Osler Securities Ltd., *Residential Mortgages as Investments*, London, Ontario.

fully invested, he had to be willing to make an advance commitment of his funds but could not be certain of the yield he would receive. Most vendors insist that investors commit themselves to renewal of five year term mortgages at the then current rate of interest for an additional five year term.

While the size of a package may vary, most vendors are not interested in deals of less than $100,000. If an institution wishes to purchase a smaller amount, it is encouraged to invest in one of the many available pooled mortgage funds unless there is a likelihood of continuing "repeat" sales.

Pricing a Package of Mortgages

Mortgages differ from other securities in that they are typically repaid through a series of equal monthly blended interest and principal payments. They are also different in that they can be prepaid by the non-corporate borrower under certain circumstances. For example, a mortgage with an original term of 25 years could be repaid at any time after five years upon payment of a three month interest bonus.

The uncertainty of the final term creates problems in the pricing of mortgages. For example, if a purchaser buys a mortgage at a premium in order to acquire the favorable stated interest rate only to find that the mortgage is repaid early, his actual yield will be less than anticipated. Conversely, if a mortgage is priced at a discount and is repaid early, the actual yield to the purchaser is higher than anticipated.

There are two types of single family mortgages which are likely to be traded: those with the term equal to the amortization period and those with a five year term and longer amortization period. NHA mortgages were once issued with long initial terms, such as 25 years. Since the actual term was uncertain, the practice that evolved was to assume a term of one half the remaining stated term to maturity for purposes of pricing the mortgage. For example, a mortgage which was to mature in 22 years would be priced as if it had a term of 11 years. Yield tables have been provided by CMHC to assist in this calculation.[3] The bulk of mortgages traded today have an initial term of five years. In this case, the established practice is to employ the remaining term to maturity for pricing purposes. For example, a mortgage dated January 1974 with a five year term and 20 year amortization period would be priced in January, 1975 as having a four year term.

A simple yield calculation is shown in Table 17-1. The reader will note that the yield is computed net of a servicing fee which goes to the servicer of the mortgage in return for his administrative activities.

3 For the reader interested in more details on the pricing of mortgages, see *Insured Mortgages as Investments: A Guide to Investment Opportunities in NHA Mortgages*, Ottawa: CMHC, 1970.

Sample Yield Calculation For A Mortgage	Table 17-1
Interest Coupon	11 5/8 %
Servicing Fee	3/8 %
Net Interest Received	11 ¼ %
Remaining Term	5 years
Remaining Amortization	25 years
Price	100.92
Approximate Net Yield to the Investor*	11%

* Based on mortgage yield tables supplied by CMHC.

Source: Canmort Consultants Ltd., *The Secondary Mortgage Market,* Toronto.

Mortgages selling at a premium are somewhat less desirable than those selling at a discount. Investors prefer to "lock-in" a yield for a specific period of time. When the general level of interest rates is lower than the mortgage coupon rate, the mortgage normally sells at a premium. However, this mortgage is more likely to be pre-paid so that the consumer can take advantage of a lower rate. Also, when a mortgage is sold at a premium and the borrower defaults, the lender is only covered for the face amount of the mortgage and not for any premium that he may have paid. With the newer five year "rollover" mortgages, it becomes more difficult for the lender to decide the amount of premium or discount to pay for a mortgage because the term to maturity is so short.

Due to the uncertainty associated with the timing of mortgage advances, the quoted yield on fully advanced mortgages is normally lower than mortgages which are not fully advanced.

Size and Development of The Secondary Market

Under the National Housing Act (NHA) passed in 1954, CMHC is empowered to sell NHA mortgages to NHA approved lenders. In addition, NHA approved lenders are permitted to sell NHA mortgages as long as the servicing is retained by an approved lender. In the period 1954 to 1961, out of over $3.1 billion in NHA mortgages originated, $266 million were sold by CMHC and the approved lenders, primarily to pension funds.

Beginning in 1961, CMHC became a more active participant in the secondary market. In an effort to promote the purchase of mortgages by non-approved lenders and to make mortgages more liquid, CMHC began to periodically auction mortgages from their portfolio. These mortgages were sold by tender to approved lenders and members of the Investment Dealers Association of Canada. Some of these mortgages were later resold to pension funds. The size of the blocks of mortgages varied from $250,000 to $500,000. In 1966, these auctions were discontinued because of heavy pressure in the market for long-term funds. Table 17-2 provides details of these mortgage originations.

CMHC Auctions of Insured Mortgages, 1961-1965 — Table 17-2

		Bids Received	Allotments Made $ millions		Accepted Bids							
					Average Price $				Average Yield* %			
Date of Auction		$ millions	Options	Total	6%	6¼%	6½ %	6 ¾ %	6%	6¼%	6½ %	6 ¼ %
1961	June 19	30.00	—	12.50	—	—	—	101.17	—	—	—	6.58
	Aug. 29	21.00	3.75	13.50	—	—	—	101.35	—	—	—	6.55
	Nov. 21	30.50	6.25	15.00	—	—	—	101.79	—	—	—	6.49
1962	Mar. 20	60.25	1.50	15.00	97.60	—	—	—	6.35	—	—	—
	Nov.20	57.00	18.50	30.00	97.20	—	—	102.26	6.39	—	—	6.43
1963	Jan. 22	40.00	6.50	27.25	96.55	—	—	101.97	6.49	—	—	6.47
	May 28	95.75	17.25	35.00	97.61	—	—	102.70	6.36	—	—	6.39
1964	Feb. 25	113.25	14.75	25.00	97.69	—		102.64	6.36	—		6.39
	May 20	113.25	16.00	25.00	97.85	—	100.97	—	6.33	—	6.37	—
	Sept. 23	115.50	6.00	25.00	99.24	—	101.00	—	6.12	—	6.36	—
	Dec. 15	84.50	16.25	25.00	98.24	—	100.96	—	6.27	—	6.37	—
1965	Mar. 10	119.75	23.50	30.00	98.41	99.96	—	—	6.26	6.26	—	—
	May 19	135.50	19.50	26.50	98.32	99.66	—	—	6.26	6.30	—	—

* Based on life expectancy of half the remaining term of the mortgage.

Source: CMHC, *Canadian Housing Statistics*, various issues.

CMHC has also played an active role in the promoting of a mortgage market by changing the characteristics of NHA mortgages, making short-term loans to approved lenders and generally providing data on mortgages. In addition, CMHC has conducted conferences with pension fund managers in an effort to inform them about mortgage investments.

There is little data available on the size of the secondary market. The only information that is available relates to NHA insured mortgages. It is gathered by CMHC and is outlined in Tables 17-3 and 17-4. The data in these tables are crude and must be interpreted with caution.[4] They are intended to identify arms-length trading between non-affiliated firms; however, in some cases, parent-subsidiary trades have been included in the data. There is also reason to believe that the data are incomplete due to a failure to report transactions properly.

As indicated in Table 17-3, banks have been substantial originators of mortgages except for the period 1960 to 1966 when they withdrew from the market. From 1966, banks concentrated on building up their own portfolios and did not become major suppliers of mortgages until 1972. As the mortgage originating capacity of banks passes their own investment needs, they will likely become much more aggressive in the market. Life insurance companies have been relatively inactive in this area but through non-insurance subsidiaries, they do originate mortgages for others. Trust and loan companies have been active originators for a number of years. CMHC was a force in the market during its auction period, from 1961 to 1965, but has been inactive ever since. Banks were net purchasers of mortgages during the period they withdrew from the origination market but have purchased few mortgages since that time.[5] Purchases by life insurance, trust and loan companies expand in easy credit periods and contract under restrictive conditions. Pension funds, real estate investment trusts and mortgage investment companies continue to be large net purchasers of mortgages.

Table 17-4 provides additional insight into the secondary market by outlining the institutions on each side of the trades. A major client of chartered banks is the "corporate sector", most notably the real estate investment trusts. Banks also appear to be the largest suppliers to pension funds. In 1972, 1973 and 1974, there were large sales of mortgages by loan companies to banks. Most banks have captive mortgage loan companies. When mortgages are originated for these companies by a bank, they are often not recorded as trades. However, a mortgage company owned by the Canadian Imperial Bank of Commerce, Kinross Mortgage Corporation, sells mortgages to the Canadian Imperial Bank of Commerce. This relationship accounts for a major portion of loan company sales to banks from 1972 to 1974. Since pension funds are not typically approved mortgage lenders,

4 In spite of the data limitation, they are included on the principal that they are the best available at present.

5. The large purchases of mortgages by banks from 1972-1974 is primarily attributed to the origination by Kinross of mortgages for the Canadian Imperial Bank of Commerce. This is not a true secondary market activity.

Sales and Purchases of NHA Insured Mortgages, 1955-1974* ($ millions)

Table 17-3

Period	Chartered Banks	Life Insurance Companies	Trust Companies	Loan and Other Companies	CMHC	Other Firms and Institutions: Pension Funds	Other Firms and Institutions: Corporate	Other Firms and Institutions: Unincorporated	Total
Sales									
1955	13.5	—	3.4	0.6	—	—	—	—	17.5
1956	33.3	5.1	8.2	2.5	0.6	—	—	—	49.7
1957	41.2	8.6	9.7	2.1	0.6	—	—	—	62.2
1958	32.5	7.8	4.4	1.5	1.5	—	—	—	47.7
1959	36.8	1.9	3.4	0.1	0.4	—	—	—	42.6
1960	6.3	9.0	4.3	7.3	0.4	—	—	—	27.3
1961	—	—	19.3	2.6	40.0	—	—	—	61.9
1962	0.7	—	47.1	5.9	47.9	—	—	—	101.6
1963	0.2	1.0	58.9	7.9	61.1	—	—	—	129.1
1964	3.1	5.0	58.2	8.4	75.3	—	—	—	150.0
1965	0.7	0.5	52.2	2.2	80.8	—	—	—	136.4
1966	15.1	—	70.0	3.2	—	—	—	—	88.3
1967	1.6	—	65.8	0.6	—	—	—	—	68.0
1968	16.8	2.9	23.3	—	—	—	—	—	43.0
1969	39.9	17.8	65.8	4.1	—	—	—	—	127.6
1970	47.9	4.3	74.9	2.8	—	—	—	—	129.9
1971	33.8	2.1	22.8	4.0	21.4	—	—	—	84.1
1972	182.7	—	38.7	422.0	—	—	—	—	643.4
1973	190.0	—	71.3	141.3	—	—	—	—	402.6
1974	180.2	1.0	146.5	261.7	—	—	—	—	589.4
Purchases									
1955	—	2.7	—	0.1	—	14.7	—	—	17.5
1956	—	8.6	0.5	3.0	—	35.3	2.3	—	49.7
1957	—	10.3	0.8	—	—	31.2	19.9	—	62.2
1958	—	4.6	2.3	—	—	31.2	9.6	—	47.7
1959	—	3.4	0.1	—	—	38.1	1.0	—	42.6
1960	—	0.4	0.8	6.5	—	12.9	6.7	—	27.3
1961	18.3	11.5	14.7	—	—	4.6	12.8	—	61.9
1962	30.6	22.1	21.4	—	—	19.6	7.8	0.1	101.6
1963	49.1	15.6	24.8	3.6	—	23.3	12.3	0.4	129.1
1964	46.8	21.4	25.8	10.9	3.1	17.1	24.9	—	150.0
1965	31.6	25.3	30.2	7.5	—	5.7	35.5	0.6	136.4
1966	19.7	33.2	3.1	7.7	—	23.6	0.2	0.8	88.3
1967	4.9	56.3	1.7	2.2	—	2.1	0.8	—	68.0
1968	2.2	9.9	4.3	2.0	—	8.5	16.0	0.1	43.0
1969	0.1	50.3	—	3.0	—	59.3	14.8	0.1	127.6
1970	0.2	66.3	1.1	0.8	—	30.5	30.9	0.1	129.9
1971	28.0	7.4	4.4	0.5	—	24.3	14.5	5.0	84.1
1972	427.2	11.2	20.2	14.8	—	48.7	115.1	6.2	643.4
1973	120.0	27.8	33.3	48.1	2.0	50.9	105.3	15.2	402.6
1974	253.7	55.4	33.6	6.2	—	101.1	125.1	14.3	589.4

* Data for initial sales and purchases only.

Source: CMHC, *Canadian Housing Statistics*, various issues.

Sales and Purchases of NHA Insured Mortgages 1971-74*

Table 17-4

	Sales To								
							Other Firms and Institutions		
Lending Institution Making Sale	Chartered Banks	Life Insurance Companies	Trust Companies	Loan and Other Companies	CMHC	Pension Funds	Corporate	Unincorporated	Total
1971									
Chartered Banks	–	–	–	0.6	–	14.3	14.9	4.9	34.7
Life Insurance Companies	2.0	–	0.1	–	–	–	–		2.1
Trust Companies	6.8	5.9	4.4	–	–	9.3	0.3	–	26.7
Loan and Other Companies	1.8	1.5	–	–	–	0.7	–	0.1	4.1
CMHC	21.4	–	–	–	–	–	–	–	21.4
Other Firms and Institutions	1.2	–	–	0.1	–	–	–	–	1.3
Total	33.2	7.4	4.5	0.7	–	24.3	15.2	5.0	90.3
1972									
Chartered Banks	0.5	5.4	14.7	11.2	–	43.9	109.2	4.6	189.5
Life Insurance Companies	–			–	–	–	–	–	–
Trust Companies	6.3	5.9	9.5	3.5	–	6.3	6.0	3.6	41.1
Loan and Other Companies	432.2	–	–	0.1	–	–	–	–	432.3
CMHC	–	–	–	–	–	–	–	–	–
Other Firms and Institutions	1.0	–	–	–	.		1.8	.	2.8
Total	440.0	11.3	24.2	14.8	–	50.2	117.0	8.2	665.7
1973									
Chartered Banks	0.3	8.5	12.3	72.6	–	27.3	91.1	8.0	220.1
Life Insurance Companies	–	–	–	–	–	–	–	–	–
Trust Companies	1.2	14.6	15.2	1.7	–	19.6	13.6	6.3	72.2
Loan and Other Companies	120.2	14.5	20.7	0.7	2.0	9.2	1.6	2.2	171.1
CMHC	–	–	–			.	–	–	–
Other Firms and Institutions	1.9		1.4	0.1	–		3.4	1.1	7.9
Total	123.6	37.6	49.6	75.1	2.0	56.1	109.7	17.6	471.3
1974									
Chartered Banks	3.3	5.7	18.7	15.2	–	52.4	99.4	2.9	196.6
Life Insurance Companies	0.7	1.0	–	–	–	–	–	–	1.7
Trust Companies	2.2	50.0	14.4	1.4	–	40.9	28.0	11.7	148.6
Loan and Other Companies	253.2	0.2	4.1	–	–	16.8	0.1	0.3	274.7
CMHC	–	–	–	–	–	–	–	–	–
Other Firms and Institutions	0.7	–	0.5	1.0	–		–	0.2	2.4
Total	260.1	55.9	57.7	17.6	–	110.1	127.5	15.1	624.0

* Data in this Table include initial and subsequent sales. Thus, totals exceed those for Table 17.3.

Source: CMHC, *Canadian Housing Statistics*, various issues.

they are net buyers of mortgages. A drawback of the material contained in the tables under consideration is that pension fund data often do not include mortgages originated by trust companies and banks because these mortgages are registered originally in the name of the pension fund instead of the approved lender if the take out commitment has been signed. As a result, mortgage purchase activities of pension funds have been substantially underestimated.

Although the secondary market is at an early stage of development, there are several institutions which could develop as active buyers and sellers of mortgages. Most of the chartered banks and major trust companies have participated in this market to some degree.[6] Some of the more active originators are relatively small firms such as Fidelity Trust, Morguard Trust, and Canmort Consultants.

Fidelity Trust, a federally incorporated firm with its head office in Winnipeg, has adopted a clear strategy of originating mortgages (primarily single family NHA's) for inventory and subsequent resale. Although the firm originates mortgages in all geographical areas west of Toronto, the bulk of the mortgages are from Western Canada. The largest proportion of the firm's business is mortgage loans, of at least $1 million each, sold to pension funds and other institutions. These are sold exclusively through investment dealers such as: McLean, McCarthy & Company; Midland-Doherty; Wood Gundy; and McLeod, Young, Weir and Company. The firm also sells mortgages to retail accounts in sizes of $50,000 to $250,000 through such firms as Pemberton Securities.

Morguard Trust began operating in 1966 as an agent for pension funds in the mortgage market. They were an NHA and a MICC approved lender almost from the outset. In 1972, they established a subsidiary trust company. Presently, they act as a specialized private trust company dealing with large pension funds which are internally managed. Although Morguard has all the powers of a trust company, they do not currently accept term deposits. Since their own assets are small compared with other financial institutions, their inventory is primarily limited by outside borrowings and their permitted liability to capital ratio. At present, the only inventories held by this institution for any length of time are mortgages which are pre-committed to pension funds for take out on completion. Morguard's lending activities have been primarily in the conventional multiple family dwelling and commercial and industrial fields, but the firm is beginning to enter the single family area as well.

Canmort Consultants Limited has been in the mortgage market for a number of years. The firm is actively involved in mortgage origination and in bringing mortgage originators and investors together. It has recently become an affiliate of Wood Gundy. This type of relationship is one which a number of investment dealers are currently contemplating.

6. At least one group has suggested that the mortgage market is "an administered market and not responsive to traditional forces of supply and demand", primarily due to the persuasive influence of chartered banks. For a more detailed discussion, see *A Brief by the Ontario Mortgage Brokers Association to the Government of Ontario*, Toronto: The Ontario Mortgage Brokers Association, January 1975.

Trading facilities and a good information network assist the secondary market. As will be discussed, the Federal Mortgage Exchange Corporation may serve these functions. The Vancouver Stock Exchange has discussed the possibility of trading mortgage units guaranteed by the British Columbia Government, but no definite plans have been made. In addition to the "offering sheets" and informal contacts that are available, a new mortgage listing service was attempted in Toronto in 1974. The firm, Morlist Limited, sold a bi-monthly publication, *The Money Market Place*, which listed a variety of mortgages for purchase and sale. Early publications included both first and second mortgages on single family, commercial and industrial properties and were aimed primarily at the smaller investor.

BARRIERS TO THE SECONDARY MARKET

The objective of this section is to discuss some of the barriers to the development of a secondary market, namely one in which existing mortgages are purchased and sold.

Problems in Carrying Inventories

In order to have a complete secondary mortgage market, there would have to be institutions which were willing to carry inventories of mortgages and to purchase and sells.

One difficulty that arises when attempting to carry an inventory is the potential gain or loss on sale if mortgage interest rates move. For example, if an institution held $1 million of mortgages with a nine percent coupon rate, and mortgage interest rates moved to 9 1/2 percent, the institution would be forced to sell these mortgages at a fairly substantial loss. This would mean that a financial institution would have to have a sizeable amount of capital before it would be able to withstand several successive capital losses.[7] Ideally, the institution should be able to stay in the market until interest rates began to fall again and then sell some of its mortgages at a premium. Since this type of institution is likely to be highly leveraged, a relatively small change in capital could have a substantial impact on the amount of inventory that the institution was able to carry.

Another difficulty an institution may encounter when trying to carry inventory is that they may be trading against the market. That is, it may find itself trying to buy mortgages at a time when other institutions do not want to sell, and selling mortgages when other institutions do not want to buy. As discussed in Chapter 2, this surplus or deficiency of mortgage funds tends to go in cycles.

Some of the existing financial institutions, such as the major life insurance and trust companies, are hesitant to originate mortgages for resale. They have long standing builder and developer clients to whom they supply funds. If they should

7. Another alternative, of course, is that the firm could also have sizeable income from other sources which would more than offset these losses.

promise loans to customers based upon anticipated resales which did not materialize, the institution would be in a cash bind and may even be viewed as somewhat unreliable by their customers. This indicates how an institution which originates for inventory can be at the mercy of market forces.

Accounting and Mortgage Trading

In 1971, a research study, *Accounting for Trust and Loan Companies in Canada*, was carried out under the auspices of the Canadian Institute of Chartered Accountants.[8] One of the observations of the authors was that "[in]...a great many cases, investment managers have refrained from disposing of securities because of the unfavourable consequences of showing losses in the financial statements, even though in many cases the proceeds of such disposal could be invested in securities of equal quality at higher yields".[9] These authors recommended the "deferral and amortization method" of accounting for mortgage sales wherein all gains or losses on the sale of securities would be written off over the period from the date of the sale of the securities to the maturity date of the securities sold. Although this proposal was not adopted by the Institute, it does have some appeal as it is a useful way of reducing a barrier to trading of securities. It is interesting to note that the capital market is not "efficient" partly because of this information barrier. One may speculate that this makes mortgage interest rates marginally higher than they would otherwise be.

Life insurance companies must have assets at least equal in value to their liabilities. The basis of valuation of these assets is determined by the Superintendent of Insurance. Each year, the insurance company must set aside reserves equal to one-third of the amount by which the total book value of all securities exceeds their total market value, plus one-third of such excess, if any, for each of the two preceeding years. Since mortgages, for purposes of valuation, are assumed to have a market value equal to book value, a shift in mortgage interest rates has no effect on reserves. The result is that a decrease in the value of a mortgage only has an impact on reserves if it is sold.[10]

Several institutions have indicated that they are hesitant to sell a substantial block of mortgages at a loss because of the potential impact on profitability in a particular period. Some institutions sell mortgages at a premium and others at a discount in order to balance the gain and loss on the sales.

Mortgages are not considered as liquid as other securities. Thus, mortgages generally appear in the statements of financial institutions at cost, whereas other

8. *Accounting for Trust and Loan Companies in Canada*, Toronto: The Canadian Institute of Chartered Accountants, 1971.

9. *Ibid*, p. 11.

10. For a discussion of life insurance statutory and financial reporting accounting practices, see *Financial Reporting for Life Insurance Companies*, Toronto: The Canadian Institute of Chartered Accountants, 1973.

securities are evaluated at market. As interest rates and stock prices rise and fall, so does the value of securities. However, with mortgages, the value is constant unless the mortgage is sold.

There are other implications of a regulatory nature, relating to selling mortgages at a loss. If a financial institution is permitted to borrow up to some multiple of its capital, any time the institution sells off a mortgage at a loss and loses some of its capital, it immediately loses some portion of its borrowing power as well.

Some institutions have devised rules of thumb for determining when securities may be sold at a loss. For example, securities may be sold when the loss on the sale will be recouped within a certain number of years. Other institutions feel that as long as the funds are placed at a higher yield than the securities sold, the investor will be better off provided the new security is of equal quality. Another common rule of thumb used by portfolio managers is that the loss on the sale of the mortgage should be recovered in half of the anticipated life of the mortgage.

Other Problems Associated With Mortgage Trading

There are a number of other problems that beset institutions interested in trading mortgages. One concern is the uncertainty surrounding mortgage terms. Since the home owner has the right to prepay, the term to maturity is uncertain. This uncertainty is compounded with five year rollover mortgages, where the interest rate is not fixed for the entire amortization period.

Another minor problem, mentioned earlier, is that if an insured mortgage is sold at a premium and the borrower subsequently defaults, the amount of the premium will not be covered by mortgage insurance.

At present, institutional investors are still not very knowledgable about mortgages as investments. As a result, an educational program would be needed before one could readily buy and sell existing mortgages in the market the way bonds are bought and sold. Also, there would have to be a substantial amount of information in the market regarding available mortgages and mortgage prices. Presently, the only information available comes in the form of prospectuses which are made available by institutions attempting to sell their mortgages.

The servicing associated with a mortgage creates yet another barrier to mortgage trading. As many financial institutions profit from servicing, they are unwilling to buy or sell a mortgage unless they are able to acquire the servicing as well. This tends to inhibit the flow of mortgage funds between certain types of financial institutions. Even if the servicing is shifted from one organization to another, there are problems of shifting the servicing facilities, including registration, notification of borrowers, and transfer of files.

Another limitation to mortgage trading is the time required to investigate a mortgage as opposed to, for example, a corporate bond. Certain bonds can be purchased within a half-hour and the information necessary to make a reasonable

investment decision is readily available. Putting a package of mortgages together takes a longer time, and the data for the credit analysis is less readily available. In the case of insured house mortgages, however, many investors do not examine the individual mortgages and this is less of a problem.

Trust companies encounter some interesting considerations with regard to E,T & A accounts. One trust company decided that it was inappropriate to transfer loans from their guaranteed accounts to the accounts of trust funds that they administer. They felt there was the possibility of conflict of interest, with the company potentially being accused of passing off bad investments or inappropriately priced investments from their own portfolio to the portfolio of a client. However, they considered that there was no conflict of interest in selling loans between pension funds under their administration because in those circumstances there was no way the company itself could be benefiting at the expense of a client. Another trust company took a different approach in that it did not allow E,T & A accounts to trade with each other, particularly since the same manager could be involved with each fund. If a fund wanted to sell a mortgage, this particular trust company would buy it back rather than involve another account.

There are some minor legislative constraints that inhibit the secondary market. Under provincial trust company legislation, no more than 15 percent of the assets of an institution may be in any one loan. This could restrict the size of the transaction in which some secondary market participants may deal. It may make sense, if one wants to have a number of small institutions buying and selling mortgages in the market, to permit the 15 percent restriction only to apply to uninsured conventional mortgages and to allow these institutions to buy and sell large blocks of NHA and privately insured conventional mortgages. This regulation does not restrict any of the major financial institutions but would have an impact on small firms such as Morguard Trust.

Until recently, any firm in Ontario wishing to trade in mortgages had to be registered under the Mortgage Brokers Act and firms were discouraged from being registered under two different Acts. Consequently, investment dealers already registered under the Investment Dealers Act were not permitted to trade in mortgages. Subsequently, the Ontario Securities Commission has allowed some firms to be registered under both of these acts.

THE FEDERAL MORTGAGE EXCHANGE CORPORATION

Special Project Team

In 1970, under Part V of the National Housing Act, CMHC was instrumental in the formation of a *Special Project Team on New Financing Mechanisms and Institutions*. This team was led by M. Boyd, J. V. Poapst and T. Tyson with E. Miller and G. Rich as study leaders. In addition, over two dozen academics and practitioners participated in the study. The purpose of the study was to explore three different means of increasing the access of investors to housing finance: (1) a residential mortgage market corporation, (2) mortgage investment companies and

(3) variable terms mortgages. The Project Team recommended the adoption of all three devices. The report of the Team was recently published by CMHC.[11]

Bill C-135

On February 1, 1973, the Residential Mortgage Financing Bill was introduced for first reading. The Bill was comprised of three parts: Part I which dealt with the creation of a Federal Mortgage Exchange Corporation through passage of the Residential Mortgage Financing Act; Part II which proposed several amendments to the Loan Companies Act to permit creation of mortgage investment companies; and Part III which proposed amendments to the Income Tax Act which would give the new mortgage investment companies conduit status for tax purposes. The Bill became law on December 3, 1973. As of August 1975, several mortgage investment companies had been formed but the Federal Mortgage Exchange Corporation was not yet operational.

Structure of the Corporation

Under Bill C-135, a Federal Mortgage Exchange Corporation (FMEC) is to be formed for the purpose of enhancing the marketability of mortgages and increasing the participation of the private sector in financing residential properties. In particular, the FMEC is empowered to:

- buy and sell residential mortgages;
- undertake to buy and sell residential mortgages; and
- lend for up to one year on the security of residential mortgages. It may also make deposits with, and buy and sell the short-term obligations of, banks, credit unions and other deposit taking institutions. Other funds may be invested in certain securities permitted under the Loan Companies Act.

The initial authorized capital stock of the FMEC is limited to $100 million. The first offering of shares is to be made to the Government of Canada and more than 50 percent of the issued and outstanding shares are to be held by the Government of Canada. The Governor-in-Council is given the power to set the total borrowings of the firm but initially maximum borrowing is set at $300 million. According to the Act, the government is limited to a maximum share capital investment of $50 million and maximum loans to the corporation of $225 million. All evidence of indebtedness of the FMEC are authorized investments under the Canadian and British Insurance Companies Act, the Loan Companies Act, the Foreign Insurance Companies Act and the Trust Companies Act. They are also eligible for the investment of guaranteed trust money.

11. J.V. Poapst, *Developing the Residential Market*, I, II, III, Ottawa: CHMC, 1975.

Government Objectives of the FMEC

The Honourable S.R. Basford introduced and provided support for the FMEC.[12] He pointed out that residential mortgages are not sufficiently liquid to become a significant component of investors' portfolios. With the FMEC standing ready to buy and sell mortgages, the liquidity required by such institutions as pension funds and credit unions would be provided. According to Mr. Basford, trusteed pension funds represent the greatest potential market for mortgages. If this source would increase its mortgage investments from nine percent of assets up to 15 percent, more than $500 million would be provided to the residential mortgage market. Thus, the primary objective of this corporation would be to increase the supply of mortgage funds and hopefully to decrease the interest rate on mortgages relative to other securities.

It is important to note that the FMEC is not being formed to supply funds directly to the housing market. According to Mr. Basford:

> "In operation, FMEC will not attempt direct market intervention with the aim of stabilizing either the price or supply of mortgage funds. Its selling activities will involve processing mortgages into packages suitable for institutional portfolios. Buying prices will be determined by the demand for and supply of mortgages in the secondary market. FMEC will buy and sell mortgages at a small spread and will have an earning potential from mortgages in its own portfolio".[13]

The FMEC hopes to further promote liquidity by making loans to active mortgage traders which will presumably permit them to carry inventories for resale.

A Proposed Method of Operation

The government has provided few details as to how the FMEC will operate. However, a study by Professor Binhammer of Queen's University for the Special Project Team does suggest procedures which may be followed:[14]

- It is suggested that all approved lenders and active secondary market traders be allowed to participate. Individuals and real estate developers should not.
- Initially, only NHA and insured conventional residential mortgages should be traded.
- Mortgages would be purchased and sold under an auction system where the FMEC would package mortgages for sale at a given price and offer to buy up to a specific dollar amount at a given price.

12. The Honorable S.R. Basford, *The Residential Mortgage Financing Act: Notes on a Bill Introduced in the House of Commons*, Ottawa, February 1, 1973.
13. *Ibid*, p. 14.
14. H. H. Binhammer, "Organization and Operation of a Proposed Residential Mortgage Market Corporation," in J.V. Poapst, ed., *op. cit.*, I, pp. 28-37.

- The FMEC would commit itself to buy or sell mortgages in the future. In effect, this tends to represent an underwriting function rather than a trading function and permits the originator to make the commitment with the assurance that if rates change he can sell the mortgage to the FMEC at a fixed price.

- The minimum size of trade should be $100,000.

- Sellers may retain servicing or it may be passed on to some other approved lender.

- The FMEC would publish prices and volumes of transactions on a regular basis.

- Short-term loans would be made to mortgage lenders to help them smooth out the flow of originations. Such loans would be secured by mortgages and the amount of the loan would depend on the borrower's activity in the mortgage market.

- CMHC would be engaged to administer loans or mortgages in arrears or default.

- The FMEC would be financed through initial capital, short-term promissory notes and debt with a maturity of over five years. The debt may not be government guaranteed.

Impact of FMEC on Financial Institutions

The potential impact of the FMEC on trust and loan companies, insurance companies, banks, and pension funds was analyzed as part of the Special Project Team Study.[15] Trust companies are unlikely to sell mortgages to the FMEC but may make purchases in times of easy money. In their E,T & A business, trust companies could use the facilities of the FMEC in order to realize funds on the termination of an account. Although the lending facility of the FMEC is not expected to be used often, it could be utilized during periods when committed outflows and available inflows are temporarily out of balance. Overall, the existence of this secondary market mechanism may lead to an increase in the proportion of mortgages held.

Because life insurance companies have long-term reasonably predictable liabilities, they have emphasized return, rather than liquidity, in their portfolio. In recent years, with high interest rates, policy holders have increased their borrowing from insurance companies. Although this development was unexpected, it is unlikely to cause a substantial need for liquidity in the future. To the extent that the impact of the FMEC is to lower the interest rate on mortgages relative to

15. See, E.D.L. Miller, G.A. Golden, J.A. Galbraith, "The Potential Impact of a Residential Mortgage Market Corporation on Major Lending Institutions," and W.R. Waters, "Potential Residential Mortgage Investment by Trusteed Pension Funds and the Impact of a Residential Mortgage Bank," both in J.V. Poapst, ed., *op. cit.*, I, pp. 39-53 and pp. 54-94, respectively.

other investments, the attractiveness of mortgages to insurance companies may actually decrease.

If the FMEC is successful, it could lead to a greater liquidity in the mortgage market. This would have no impact on banks except that they may do more originating for clients. A potential impact would be felt if banks were permitted to use mortgages as part of their legal liquidity requirements. If the FMEC ceased being a neutral trader and instead tried to directly influence the supply of mortgage funds through an increase or decrease in its purchasing activity, the impact could be greater. If such activities were counter to monetary policy, they could force monetary authorities to be even tighter with banks and favor other institutions.

Since trusteed pension funds are growing rapidly, the impact of the FMEC on their activities is of particular interest to policy makers. The Special Project Team suggested that the larger pension funds sponsored by corporations would likely be affected by the FMEC. The introduction of an FMEC would permit active trading which, in turn, would assist funds in (1) altering the risk/return character of the portfolio, (2) securing trading profits, and (3) adding to cash holdings. Although admitting that such estimates were highly speculative, Waters estimated the target proportion of pension fund assets invested in mortgages at 17 to 20 percent.[16] Based on this and an assumed speed of portfolio adjustment, it was concluded that the "single best estimate" of the potential increment was $120 million in the first year, increasing to $194 million in the fifth year.[17]

CRITIQUE OF THE FMEC

The following is intended to outline some of the issues which must be faced in order to make the FMEC operational.

Ownership

Bill C-135 specified that FMEC would be initially wholly owned by the government and more than 50 percent of the outstanding shares must be held by the Government of Canada. If the firm is to be a truly neutral participant in the market, it should be forced to earn an economic return for the investors. If it is not going to be neutral, which is easier to believe, CMHC has the power currently to perform all of the desired activities including the purchase and sale of mortgages and the making of short-term loans, without forming the FMEC.

Undertakings

The FMEC may undertake to buy and sell mortgages. This means that it can conceivably make the equivalent of advance take out commitments which would

16. Waters, *Ibid*, p. 77.

17. *Ibid*, p. 92.

protect financial institutions against rate shifts. One may question whether this really represents the creation of a secondary market or an insurance device for which somebody must pay.

Liquidity

One of the primary objectives of the Bill is to promote liquidity. A study of the various types of lending institutions indicates that more liquidity is not really needed for banks, mortgage loan companies or insurance companies. Trust companies may prefer greater liquidity but they currently have other devices such as portfolio balancing, the inherent liquidity of five year term mortgages, credit lines and CMHC as a lender of last resort. Even if trust companies found liquid mortgages desirable, it is unlikely that they would substantially increase the proportion of mortgages they hold above current high levels. Pension funds and credit unions both represent targets for this bill, but it is difficult to argue that an increase in liquidity would increase the proportion of pension fund assets placed in mortgages. No study, to my knowledge, has considered the impact of the FMEC on credit unions. Thus, the conclusion one must reach is that the need for, and benefits of, liquidity have not been established, other than to comfort investors who may feel that liquidity is a virtue even if not needed. If the FMEC stood ready to purchase all mortgages offered or was willing to issue takeout commitments for a fee, it would encourage mortgage originators to take a larger forward position (i.e., funds committed but not advanced). This would encourage lenders to make mortgage loans but could lead to large mortgage loans by the FMEC in times of tight money.

Profitability

In order to function as a neutral force and, at the same time, make a profit, it will be necessary for FMEC to sell mortgages at a mark-up. It is difficult to conceive of conditions under which it will make a continuing profit unless the FMEC is willing to buy substantial amounts of mortgages during periods of tight money when rates are high and sell them during periods of easy money. If this policy is followed, the firm would be operating counter to monetary policy. Of course, one point of view is that the mortgage market suffers more than other segments of the capital markets when money is tight and, therefore, increased lending by the FMEC during periods of tight money would be appropriate. Also, if interest rates should rise intermittently over a series of years, the firm would be selling mortgages at below cost or else pricing the mortgages in such a way as to not attract any buyers at all.

Mechanics of the Institution

At the present time, there are institutions that originate and sell blocks of mortgages, as well as firms that purchase mortgages. The purchase of mortgages is more complex than the purchase of bonds, as a detailed investigation of each block is required. The only mortgages which can be sold without investigation are a package of single family NHA mortgages or, perhaps, a package of high

ratio single family mortgages. In the former case, the FMEC is essentially selling a government guaranteed instrument. There may also be problems of accumulating and breaking up packages to satisfy various buyers and sellers. Can a buyer just pick the geographical or other type of mortgages he wants to purchase? Who retains the servicing?[18]

Fledgling Secondary Market

A true secondary mortgage market is slowly developing in Canada. No study has been done, to the knowledge of this author, which looks at the implications, positive or negative, of the proposed FMEC for the future healthy development of the new institutions serving this market.

Lower Interest Rates

At the present time, financial institutions hold certain proportions of their assets in mortgages. If the FMEC makes mortgages more liquid, the supply of mortgage funds from some institutions may increase, thus pushing down interest rates. At the same time, other institutions not requiring liquidity could withdraw from the market due to lower rates. The end result is not clear but it may simply be a redistribution of mortgages among firms rather than an overall increase in supply of funds.

Valuation Problems

The difficulty of establishing a pricing mechanism for mortgages may inhibit trading. For example, commercial properties are not uniform in size, risk or repayment terms. Rental properties may also involve participation features whose values are not easily determined. The result is that the FMEC may be restricted to insured single family mortgages. These mortgages, due to the Interest Act and prepayment privileges allowed by CMHC, have an uncertain term, thus making valuation difficult. When the auction selling technique is used, part of the problem is eliminated, as the price is set at the time of sale and no continual quotations are required.

Accounting For Gains and Losses

A decision to trade any security should be based on anticipated rates of return. When the sale of a current holding and the purchase of another of equal quality leads to an increase in the present value of future cash flows, the trade should be made. Whether there is a book profit or loss should not be a factor in the sale decision. In time, this activity of improving the present value of cash flows will result in a greater level of assets than if no trading had been accomplished.

18. As a matter of interest, in the 1961-65 auctions there was little investigation of CMHC mortgages. In fact, CMHC did not give out sufficient information for such an investigation to take place. CMHC auctions involved packages by municipality and CMHC would keep the servicing or would allow an approved lender to acquire the servicing along with the mortgage with no effect on the purchase price.

Certain financial institutions are permitted to value mortgages in their books at amortized cost, whereas other types of securities are often carried at market values. Mortgages acquired at par would be carried at cost, while those acquired at a discount or premium would be carried at amortized cost. Under conventional accounting practices, unrealized losses on mortgages would not be reflected in the income statement or on the balance sheet of the institution. By comparison, realized losses would have the impact of reducing both net income after realized losses and the book value of assets in the year that the loss was realized. In subsequent years, net income would be greater and, in time, the level of assets used for capital tests would be higher.

There is a further advantage in realizing a loss in that the loss can be carried forward to offset tax on any gains that are realized. In effect, the realization of the loss creates a potential asset. Thus, the fact that most managers seem to avoid the questions that arise in response to a realized loss and the short-run ramifications on income and capital, lead them to prefer to sell mortgages when rates are low and buy mortgages when rates are high. It is exactly at these times that the supply of funds available to most firms would suggest that they do the opposite.

Until these firms realize the impact on their total position of not maximizing their returns, and remain reluctant to realize losses, any level of trading volume will remain lower than it could be.

Chapter 18

The Mortgage Market: Past and Future

The objective of this chapter is to briefly summarize the major changes which have occurred in the mortgage market in recent years and to speculate on the changes that may occur in the future. The areas that will be covered include the size of the market, mortgage lenders, other market participants, mortgage loan characteristics and government intervention.

MARKET SIZE

The most noticeable aspect of the mortgage market over the last decade has been its rapid increase in size. From 1964 to 1974, the dollar volume of mortgage lending by financial institutions tripled with most of the growth taking place between 1970 and 1973. This growth was the result of several factors:

- the heavy demand resulting from changing demographic characteristics and rising real incomes;
- the ability and willingness of financial institutions and individuals to provide substantial amounts of funds; and
- the impact of inflationary pressures on land and construction costs.

In the early part of the past decade, lending for multiple family dwellings grew rapidly, while in recent years the balance has again shifted toward loans for single family dwellings. As the volume of mortgage lending increased, the need for interim financing increased as well. This need was met by existing institutions and a number of new firms, many of which were sponsored by foreign investors.

The question is, will this growth continue and what form will it take? The demographic data presented in Chapter 2 suggests that for the next few years, the demand for housing will continue to grow. However, by 1985, that growth should slow and housing demand may even decline as the "baby boom" passes through the house-buying stage. This presumes no major change in Canada's immigration policy, a policy which is currently under review. Due to rising material and labor costs, a shortage of serviced land in the large metropolitan areas, and changing demographic characteristics, there may be another surge in the construction of multiple family structures. In addition, increased government involvement may encourage more socially oriented housing.

MORTGAGE LENDERS

As noted above, the rapid increase in mortgage lending over the last decade can be partly attributed to the growth of existing financial institutions, an increase in the proportion of institutions' investments devoted to mortgages and the creation of a number of new mortgage lending institutions. Trust companies, loan companies, banks and credit unions have grown rapidly and increased their proportion of assets devoted to mortgages. Insurance companies have not expanded as quickly and the proportion of assets going into mortgages has remained stable. Pension funds have become a major force in the capital markets although their unwillingness to make mortgage loans has been disappointing to some. Real estate investment trusts and mortgage investment companies, two institutions new to Canada, were initiated in the 1970's and have expanded rapidly. A number of chartered banks have, over the last decade, created new subsidiaries which operate almost exclusively in the mortgage market. In addition, a number of firms, particularly trust companies, now offer units in mortgage funds to clients such as pension plans, registered retirement savings plans and estate, trust and agency accounts.

What will the role of these mortgage lenders be in the future? The supply of mortgage funds by any given lender will depend on the general availability of funds, the ability of the lender to successfully attract the available funds and, finally, the relative attractiveness of mortgages compared to other investments. In the short term, the return to a healthy economy, large demands by governments, and the initiation of several large capital intensive projects may keep interest rates high and funds for mortgages in short supply. Over the longer term, as the baby boom enters a net saving phase, the supply of funds available to traditional mortgage lenders may increase while housing demand levels off. If these supply and demand predictions are correct, there may be sufficient funds for the mortgage market by 1985 and some institutions, particularly trust companies, may have to modify their investment strategies. At present, the direct mortgage lending activities of the non-financial institution sector are inadequately documented and understood, although they are significant. For this reason, one may expect government and academics to conduct research into this area in the future.

The forthcoming revision of the Bank Act will bring under debate the question of competition between financial institutions. Those concerned with the mortgage market will want to observe this debate carefully. One result could be tighter government control over foreign firms acting as near-banks in Canada, many of which are active in interim financing.

Are there likely to be any new mortgage lending institutions in the near future? It is not anticipated that governments will promote the creation of any new private sector mortgage lending institutions, at least until REIT's and MIC's have been well established. Although no new REIT's appear to be contemplated, a number of new MIC's may be established. It is possible that the federal or provincial governments will set up a quasi-government institution, similar to the

Government National Mortgage Association in the United States, whereby securities, backed by a portfolio of mortgages and a government guarantee, are sold in the market. However, for the moment, MIC's, REIT's and mortgage funds are fulfilling that role.

What new regulations are likely to be imposed on mortgage lenders? Experience tells us that new regulations are inevitable. Of greatest concern to lenders are the types and amounts of investments allowed and the degree of leverage institutions are permitted. The loan to value ratio on conventional loans has been gradually increased over time. With favorable default rates and the desire to encourage housing, governments may consider increasing this ratio still further. The limit on the proportion of bank assets allocated to conventional residential mortgages is not currently binding but should it become a problem, it would probably be raised or removed. In fact, it is periodically suggested that in order to ease the housing problem, financial institutions should be required to have some minimum proportion of assets in mortgages. However, the passage of such legislation is unlikely in the forseeable future.

There is a constraint on mortgage investment activities of investment funds. Fixed income funds are limited in the proportion of assets they may devote to mortgages. In the case of mortgage funds, the sponsor must guarantee that if sale of a mortgage becomes necessary, the sponsor will purchase it. The area of fund investment policies is currently under investigation by the Ontario Securities Commission with a view to whether the present regulations are adequate. Interestingly, the creation of the Federal Mortgage Exchange Corporation could make the problem of mortgage liquidity merely academic. Over the past several years, trust and loan companies have been permitted to increase their leverage. As REIT's and MIC's become more established, the same consideration may apply to them. The startling growth and relatively unregulated status of credit unions is likely to attract the attention of regulatory and government bodies. The outcome is surely to be greater regulation.

Will the methods of administering mortgage loans change? For a variety of reasons, there appears to be a current shortage of trained mortgage lending staff in financial institutions. This situation is likely to change with in-house staff development and training programs and the development of professional educational programs. The mortgage business is becoming more complex with the introduction of new types of properties, larger loans and new lending arrangements. This will further encourage the training programs mentioned above. As builders and developers grow, they will have greater negotiating power leading to greater pressure on lenders. Some developers will enter the capital markets directly, by-passing traditional lenders completely. An increase in government programs, requiring the cooperation of the private sector, will necessitate more knowledge of such programs by lenders.

OTHER MARKET PARTICIPANTS

The late 1960's and early 1970's saw the creation and change in thrust of a number of mortgage market participants. As a result of legislation which permit-

ted financial institutions to make high ratio, privately insured loans, the existing private mortgage insurance company expanded its operations and two new companies were created. Because larger first mortgages were possible, a number of firms affiliated with financial institutions and specializing in second mortgage loans, either changed their business or became inactive. As high ratio loans became more common, the arranging of sales became slightly easier for real estate agents. The smaller mortgage brokers found business slowing down and second mortgage rates falling. The rapid growth of financial institutions expanded the need for mortgage brokers who brought borrowers and lenders together. In addition, the increasing demand by investors such as pension funds, which had no mortgage origination facilities, and the increasing complexity of deals, encouraged some mortgage brokers to expand their services to include financial advice and, in some cases, mortgage origination. Several investment dealers began to take an active interest in the mortgage business as well, either by setting up their own staff or by forming an affiliation with a mortgage broker.

How will these market participants operate in the future? The private mortgage insurance companies, after a period of consolidation, may broaden their coverage and lower their rates in recognition of favorable default rates and increased competition. The formation of the Federal Mortgage Exchange Corporation may have a profound impact. It may encourage the creation of a mortgage banking industry with participants from existing financial institutions and the larger mortgage brokers. The development of an active secondary market may further the participation of investment dealers in the mortgage business, possibly in cooperation with established mortgage brokers.

MORTGAGE LOAN CHARACTERISTICS

The characteristics of mortgage loans have changed over the last decade. Due to new legislation, the number of insured loans has increased as have loan to value ratios. The size of loans is increasing, reflecting higher house prices, a gradual increase in the size of loans that may be insured and the increased size and sophistication of developers and mortgage lenders. Yield spreads on mortgages relative to corporate bonds appear to be narrowing slightly. There has been an increased use of participation features, especially when interest rates are abnormally high. Five year term mortgages at the option of the lender are now common and the prepayment of mortgages is less difficult and expensive. Mortgages are more liquid than ever before due to an increased investor awareness and an increase in the number and size of mortgage market participants.

How might mortgage loan characteristics change in the future? The spread between mortgages and other securities may continue to narrow slightly, reflecting a greater familiarity with mortgages on the part of lenders and a slight increase in liquidity. Several financial institutions have become increasingly aware of real estate investments and, as a result, equity participations and the use of complete packages consisting of interim, mortgage, and equity financing by a single lender will become more common. The high level of uncertainty on the

part of mortgage lenders and borrowers has made them increasingly willing to accept floating rate assets and liabilities. Thus, the use of some form of a variable terms mortgage is likely to occur. In its initial stages, the rate may change less frequently than every year and more frequently than every five years. There may also be greater use of five year term mortgage loans to developers for larger properties. Mortgage interest rates may also be more sensitive to other market rates then in the past if the secondary market continues to develop. One of the aspects of mortgages which makes them unattractive to pension funds is the uncertainty surrounding the timing of mortgage draws. As the various levels of government establish better approval procedures and lenders become more willing to absorb this uncertainty and pass on fully advanced loans to pension funds, this disadvantage will decrease in importance. Builder warrantee programs will soon be adopted in several provinces. This should increase the quality of homes and, therefore, the security on mortgage loans.

GOVERNMENT INTERVENTION

Governments have been concerned with the housing and mortgage markets for many years. In recent years, CMHC has redirected its efforts from the counter-cyclical supply of funds for housing toward such activities as the financing of land assembly, sewage services and social housing. Provincial governments, often through housing authorities, have played an increasingly important role. They have loaned large sums of money, primarily derived from the Federal government, guaranteed loans, and become landlords on a large scale. A number of schemes, such as homeowner grants and tax incentives, have been attempted in order to stimulate housing. Legislation which encourages the formation of new mortgage lending institutions has been passed. Other legislation has been passed to limit rents, discourage the withholding of land from development and discourage real estate speculation. These various government initiatives have met with mixed success.

What is the government likely to do for the consumer in the future? The average home buyer has had little experience in purchasing a house yet he must deal with a number of trained professionals such as real estate brokers, mortgage brokers, lawyers and lending officers who have years of experience and who often represent powerful interests. Governments have become increasingly aware of consumer needs and it is just a matter of time before this awareness has an impact on house purchasing. The real estate and legal fees associated with house purchasing and mortgage lending have been under increasing attack. The result may be a strong government initiative under the Combines Act, more vigorous promotion of the land titles system, or a modification of mortgages to make repeat title searches less costly. Pressure to upgrade the qualifications of mortgage brokers can also be expected.

What role is the Federal government likely to play in the future? If present trends persist, the Federal government will continue to emphasize the supply of social housing and the financing of a superstructure for housing development.

This will likely be accomplished through a combination of loans and modifications of the provisions of the National Housing Act. As discussed earlier, the Federal Mortgage Exchange Corporation should be operating relatively soon. In recognition of increased provincial sensitivity, the Federal government can be expected to deal through provincial organizations rather than directly with individuals, developers and municipal governments. A perennial issue which will be raised again is whether interest on mortgages should be tax deductible. The fact that it is allowed in the U.S. is a constant reminder of the feasibility of that option.

What role are provincial governments going to play in the future? Provincial involvement with housing and its financing is likely to increase. Following the Ontario example, the provinces will probably become more active landlords and may even become more involved in urban housing planning in which there is a mixture of social and other housing. Federal, provincial and municipal cooperation is essential in order to maintain reasonable productivity. This realization is likely to lead to increased cooperation and coordination among the three levels of government. A useful start would be to provide potential house purchasers, builders, and developers with a guide to all available government programs. A strategy used in Quebec may become more widely used. The Caisse de Dépôt et Placement du Québec is an organization which professionally manages deposits on behalf of the Quebec Pension Plan and other provincial bodies. This concept of a central manager for pension and other public funds may be adopted in other provinces. In British Columbia, the government has shown a desire to work closely with credit unions to achieve social housing objectives. The large size and rapid growth of credit unions may cause this experiment to be attempted in other provinces as well.

Although governments have spent substantial sums on housing, it should be noted that government spending is still quite small compared with the private sector. Thus, governments will likely continue to emphasize incentives and legislation to encourage the private sector to allocate funds to housing rather than providing massive government funding.

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Since very little has been published in this area, the author frequently had to rely on internal memoranda, newspaper stories, annual reports and other sources. Rather than repeat all of those sources here, it was decided to provide the reader with a selection of books and periodicals which would provide an opportunity for further study of the field.

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